

# **INTERMEDIATE (IPC) COURSE**

## **STUDY MATERIAL**

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**PAPER : 2**

**BUSINESS LAW, ETHICS AND  
COMMUNICATION**

**MODULE – 1**



**BOARD OF STUDIES**  
**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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## A WORD ABOUT STUDY MATERIAL

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Laws and rules, in general, regulate the relationship between business and profession. In specific, an accounting student should have knowledge of the legal framework, which influences business transactions. This paper on Business Laws, Ethics and Communication intends to make the students aware of legal background relating to business and company law. Besides, in today's scenario, ethics form a core part of any profession and it is indeed imperative for the students of Chartered Accountancy to know the value of ethics in business. Further, a student needs to develop good business communication skills and a sound understanding of related legal deeds and documents. The syllabus is, therefore, comprehensive and has been segregated into three parts with Part I covering Business Laws and the Company Law, Part II covering Business Ethics and Part III covering Business Communication. This paper prescribes a working level knowledge of all the segments covered.

The Company Law is one of the most significant and pervasive statute amongst the various corporate legislations and so forms an important subject of the Chartered Accountancy Course. The Companies Act, 2013 has been enacted to meet the contemporary national and international economic environment and to further accelerate the expansion and growth of our economy. To keep pace with the developments the Institute has revised the syllabus of the Company Law.

- The study material is divided into 3 Modules. Module 1 covers The Indian Contract Act, 1872, The Negotiable Instruments Act, 1881, The Payment of Bonus Act, 1965, The Employees' Provident Funds and Miscellaneous Provisions Act, 1952 and The Payment of Gratuity Act, 1972, Module 2 covers The Companies Act, 2013 and Module 3 covers Ethics and Communication.
- Learning objective given at beginning of each chapter for better understanding.
- Step by step approach follow in each chapter.
- Appropriate explanation of the text through illustrations & practical examples.
- Feedback form is given in this Module wherein students are encouraged to give their feedback/suggestions.

Finally, we would welcome suggestions to make this book more helpful and 'student-friendly'. In case of any doubt, students are welcome to write at [shraddha.saxena@icai.in](mailto:shraddha.saxena@icai.in), [nisha.gupta@icai.in](mailto:nisha.gupta@icai.in), [megha.goel@icai.in](mailto:megha.goel@icai.in).

## SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2015 EDITION OVER 2014

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Sl.No.	Unit	Amendment related to the topic	Content	Page. No.
1	Unit 1- Preliminary	Associate Company	Vide General Circular no. 24/2014 dated 25th of June 2014 Ministry of Corporate Affairs issued a clarification with regard to holding of shares in a fiduciary capacity by associate company under section 2(6) of the Companies Act, 2013.	6.11
2.	Unit 1- Preliminary	Memorandum, Companies with charitable objects,& Alteration of memorandum	As per the Notification S.O. 1353(E), dated 9th Of July, 2014. In exercise of powers conferred by Section 458 of the Companies Act, 2013 & in supersession of the notification of the Government of India, MCA, dated the 10.07.2012 vide no. S.O. 1538(E), dated 10.07.2012, Central Government hereby delegates to the ROC the power & functions vested in it under the following sections of the said Act- 4(2), 8, 13(2).	6.13, 6.26, 6.29
3.	Unit 1- Preliminary	Memorandum, Companies with charitable objects, & Alteration of memorandum, Rectification of name of company and Commencement of business.	Vide Notification S.O. 1352(E) dated 21.05.2014 in exercise of powers conferred by Section 458 of the Companies Act, 2013 & in supersession of the notification of the Government of India, MCA, dated the 10.07.2012 under Section 3, Sub-Section (ii) vide no. S.O. 1539(E), dated 10.07.2012, in so far as it relates to items (a) to (f) & items (n), except as respect things done or omitted to be done before such supersession, the Central Govt. hereby delegates to the RD at Mumbai, Kolkata, Chennai, Noida, Ahmedabad, Hyderabad & Shillong, the power & functions vested in it under the following sections of the said Act, subject	6.13, 6.23, 6.30, 6.32

			to the condition that the Central Govt. may revoke such delegation of powers or may itself exercise the powers & functions under the following sections, if in its opinion, such course of action is necessary in the public interest.: 8(6), 13(4) &(5), 16, 11(3)	
4.	Unit 1- Preliminary	Registration of names of the Companies	Vide General Circular No. 29/2014 dated 11 <sup>th</sup> of July 2014 the Ministry of Corporate Affairs directed Registrar to ensure that registration of names of the Companies shall be in consonance with the provisions of the Emblems and Names (Prevention of Improper Use) Act, 1950	6.28
5.	Unit 1- Preliminary	Registration of names of the Companies	General Circular No. 02/2014, dated 11.02.2014 was issued on the use of word 'National' and 'Bank' in the names of Companies or LLP	6.27
6.	Unit 2- Prospectus	Private Placement	As per the Companies (Prospectus and Allotment of Securities) Amendment Rules, 2014, dated 30th June 2014 further a new proviso has been added with respect to an offer or invitation for non-convertible debentures	6.61
7.	Unit 2- Prospectus	Acceptance of deposits from public	As per the Companies (Removal of Difficulties) Second Order, 2014 dated 2nd of June, 2014, Central government makes an order to remove certain difficulties that have arisen in giving effect to the provisions of Section 73.	6.64
8.	Unit 2- Prospectus	Acceptance of deposits from public	As per the Companies (Removal of Difficulties) Fourth Order, 2014 dated 6th of June 2014, the Central Government hereby makes the order that until a date is notified by the Central Government, the Company Law Board shall exercise the jurisdiction, powers, authority and functions of the Tribunal .	6.65

9.	Unit 3- Shares and Share Capital	Further issue of Capital	As per the Companies (Share Capital and Debenture) Amendment Rules, 2014, dated 18th of June, 2014, after Sub-Rule (2) of rule 13 related to issue of shares on preferential basis, following sub-rule (3) has been inserted stating that the price of shares or other securities to be issued on preferential basis shall not be less than the price determined on the basis of valuation report of a registered valuer.”	6.85
10.	Unit 3- Shares and Share Capital	Debenture	Conditions for the issue of secured debentures by a company prescribed under the Companies (Share Capital and Debentures) Rules, 2014. And inclusion of amendment as per the Companies (Share Capital and Debentures) Amendment Rules, 2014 .	6.103
11.	Unit 3- Shares and Share Capital	Debenture redemption reserve (DRR) account	After the “RBI (Amendment) Act, 1997” the following is inserted “and for Housing Finance Companies registered with the National Housing Bank” as per the Companies (Share Capital and Debentures) Amendment Rules, 2014]	6.104
12.	Unit 4- Meetings	Voting and right to demand a poll	Vide Notification dated 19th March, 2015, Central Government further amended the Companies(Management and Administration) Rules, 2014 by issuing the Companies (Management and Administration) Amendment Rules, 2015 whereby replacing the rule 20 of the Companies (Management and Administration) Rules, 2014 relating to the Voting through electronic means.	6.149
13.	Unit 4- Meetings	Declaration in respect of beneficial interest in any share	A proviso has been inserted under Rule 9 sub rule 3 by the Companies (Management and Administration) Second Amendment Rules, 2014 with respect to section 89 of the Companies Act, 2013	6.123

14.	Unit Meetings 4-	Return to be filed with Registrar in case promoters' stake changes	As per the Companies (Management and Administration) Second Amendment Rules, 2014, through Notification dated 24 <sup>th</sup> July 2014, a changes have been carried out in the Companies (Management and Administration) Amendment Rules, 2014 in Rule 13(Stated above) whereby the words "either value or volume of the shares" is omitted along with the explanation giving meaning of 'change.'	6.126
15.	Unit Meetings 4-	Place of keeping and inspection of registers, returns, etc	Vide Notification dated 31st March, 2015, the Central Government hereby delegates to the Regional Directors at Mumbai, Kolkata, chennai, Noida, Ahmedabad, Hyderabad and Shillong, the powers and functions vested in it under sub-section (5) of section 94 of the Companies Act,2013.	6.126
16.	Unit Meetings 4-	Resolution requiring special notice	Vide Notification G.S.R. 537(E), dated 24 <sup>th</sup> July 2014, by the Companies(Management and Administration)Second Amendment Rules, 2014, in rule 23 subrule(1), for the words " not less than five lakh rupees", the words " not more than five lakh rupees" shall be omitted)	6.159



# STUDY PLAN – KEY TO EFFECTIVE LEARNING

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## Study Tips

Since the level of knowledge required for the subject is 'working knowledge' and the objective is to gain knowledge of those branches of laws relating to business transactions, certain corporate bodies and related matters and their application to practical commercial situations, students need to prepare on these lines. For this, they have to focus their study based on the major legal provisions, case laws, if any, and understand their practical implications. Besides, students should also give importance to the terms/definitions for proper conceptualisation of the answers.

As stated earlier, students should also go through the Bare Acts to get a better understanding of the provisions contained in various statutes.

A comprehensive study of the subject can be done by keeping the following points in the mind:

- Make a study plan covering the entire syllabus and then decide how much time you can allocate to the subject on daily/weekly basis.
- Maintain the time balance amongst various subjects such as purely descriptive type and numerical-based papers.
- First of all, have an overview of the chapter to understand the broad contents and sequence of various sub-topics.
- Do the introspection while going through the chapter and ask various questions to yourself.
- Read each chapter slowly to ensure that you understand and assimilate the main concept. If need be, read once again with concentration and then try to attempt exercise at the end of the chapter or given in the Practice Manual.
- Recapitulate the main concept after going through each chapter by way of brief notes.
- Always assess your preparation periodically, say, on monthly basis. If necessary, revise your plan and allocate more time for the subject in which you feel deficient.
- Read, understand and assimilate each chapter.
- Always try to attempt the past year examination question paper/ Mock Test Papers under examination conditions.
- Revision of material should never be selective in any case. Because broad coverage of the syllabus is more important than preparing 2-3 chapters exhaustively.

## **Examination Techniques**

- Plan your time so that equal time is awarded for each mark. Keep sometime for revision as well.
- Always attempt to do all questions. Remember that six average answers fetch more marks than five best answers. Therefore, it is important that you must finish each question within allocated time.
- Read the question carefully more than once before starting the answer to understand very clearly as to what is required by the paper-setter.
- Always be concise and write to the point and do not try to fill pages unnecessarily.
- There must be logical expression of the answer.
- Answer the problem oriented questions by explaining the relevant /applicable provisions of the relevant enactments followed by answers thereof.
- In case a question is not clear, you may state your assumptions and then answer the question.
- While writing answers in respect of essay-type questions, try to make sub-readings so that it catches the examiner's eye.
- Revise your answers carefully underline important points before leaving the examination hall.

**Best Wishes and Happy Learning**



# SYLLABUS

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## PAPER – 2: BUSINESS LAW, ETHICS AND COMMUNICATION

*(One paper – Three hours — 100 Marks)*

**Level of Knowledge:** Working knowledge

### PART I – BUSINESS LAW (60 MARKS)

#### **Objective:**

To test working knowledge of Business Law and Company Law and their practical application in commercial situations.

#### **Contents**

##### **Business Law (30 Marks)**

1. The Indian Contract Act, 1872
2. The Negotiable Instruments Act, 1881
3. The Payment of Bonus Act, 1965
4. The Employees' Provident Fund and Miscellaneous Provisions Act, 1952
5. The Payment of Gratuity Act, 1972.

##### **Company Law (30 Marks)**

The Companies Act, 2013 – Sections 1 to 122

- (a) Preliminary
- (b) Incorporation of Company and Matters Incidental thereto
- (c) Prospectus and Allotment of Securities
- (d) Share Capital and Debentures
- (e) Acceptance of Deposits by companies
- (f) Registration of Charges
- (g) Management and Administration
- (i) Company Law in a computerized Environment – E-filing.

#### **Note:**

- (i) The provisions of the Companies Act, 1956 which are still in force would form part of the syllabus till the time their corresponding or new provisions of the Companies Act, 2013 are enforced.

- (ii) If new legislations are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from a date notified by the Institute.

## **Part II – ETHICS (20 Marks)**

### **Objective:**

To have an understanding of ethical issues in business.

### **Contents:**

#### **1. Introduction to Business Ethics**

The nature, purpose of ethics and morals for organizational interests; Ethics and Conflicts of Interests; Ethical and Social Implications of business policies and decisions; Corporate Social Responsibility; Ethical issues in Corporate Governance.

#### **2. Environment issues**

Protecting the Natural Environment – Prevention of Pollution and Depletion of Natural Resources; Conservation of Natural Resources.

#### **3. Ethics in Workplace**

Individual in the organisation, discrimination, harassment, gender equality.

#### **4. Ethics in Marketing and Consumer Protection**

Healthy competition and protecting consumer's interest.

#### **5. Ethics in Accounting and Finance**

Importance, issues and common problems.

## **Part III – COMMUNICATION (20 Marks)**

### **Objective:**

To nurture and develop the communication and behavioural skills relating to business

### **Contents:**

#### **1. Elements of Communication**

- (a) Forms of Communication: Formal and Informal, Interdepartmental, Verbal and non-verbal; Active listening and critical thinking
- (b) Presentation skills including conducting meeting, press conference
- (c) Planning and Composing Business messages
- (d) Communication channels
- (e) Communicating Corporate culture, change, innovative spirits

- (f) Communication breakdowns
- (g) Communication ethics
- (h) Groups dynamics; handling group conflicts, consensus building; influencing and persuasion skills; Negotiating and bargaining
- (i) Emotional intelligence - Emotional Quotient
- (j) Soft skills – personality traits; Interpersonal skills ; leadership

**2. Communication in Business Environment**

- (a) Business Meetings – Notice, Agenda, Minutes, Chairperson’s speech
- (b) Press releases
- (c) Corporate announcements by stock exchanges
- (d) Reporting of proceedings of a meeting

**3. Basic understanding of legal deeds and documents**

- (a) Partnership deed
- (b) Power of Attorney
- (c) Lease deed
- (d) Affidavit
- (e) Indemnity bond
- (f) Gift deed
- (g) Memorandum and articles of association of a company
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# The Indian Contract Act, 1872

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## UNIT- I : BACKGROUND

### Learning objectives

After studying this unit, you would be able to -

- ◆ Understand the meaning of the terms 'agreement' and 'contract' and note the distinction between the two.
- ◆ Note the essential elements of a contract.
- ◆ Be clear about various types of contract.
- ◆ Understand the concept of offer and acceptance and rules of communication and revocation thereof.

Any commercial activity requires 'understanding' among people concerned. This understanding is often reduced into writing to give effect to the intention of the parties. Such formal versions are known as contracts. These contracts define the rights and obligations of various parties to facilitate easy performance of the contractual obligations.

The Indian Contract Act, 1872 codifies the legal principles that govern such 'contracts'. The Act basically identifies the ingredients of a legally enforceable valid contract in addition to dealing with certain special type of contractual relationships like indemnity, guarantee, bailment, pledge, quasi contracts, contingent contracts etc.

### 1.1 What is a Contract?

While all contracts are agreements, all agreements are not contracts. An agreement which is legally enforceable alone is a contract. Agreements which are not legally enforceable are not contracts but remain as void agreements which are not enforceable at all or as voidable agreements which are enforceable by only one of the parties to the agreement.

The above observation would raise a question in our minds as to what is the exact meaning of the words 'agreements' and 'contracts'.

An Agreement is a promise or a commitment or set of reciprocal promises or commitments. An Agreement involves an offer or proposal by one person and acceptance of such offer or proposal by another person. If the agreement is capable of being enforced by law then it is a contract.

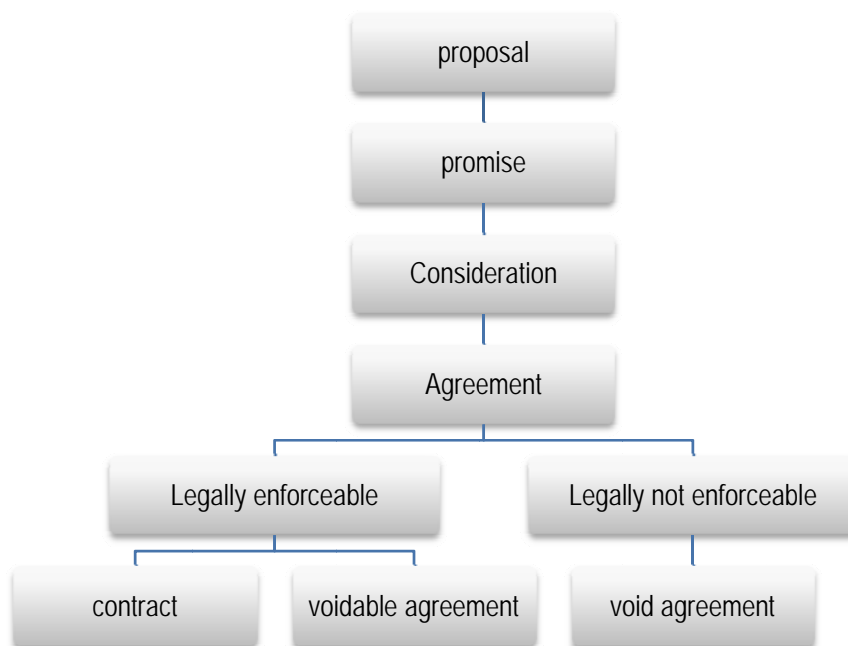


## 1.2 Business Law, Ethics and Communication

Now let us take a look at the definitions as per the Act. Section 2(b) while defining a 'promise' provides that "when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. Proposal when accepted becomes a promise".

Section 2(e) of the Act defines an agreement as 'every promise and every set of promises forming consideration for each other'. Section 2(h) of the Act defines the term contract as "an agreement enforceable by law".

The above discussion can be diagrammatically represented as follows:



## 1.2 Essentials of a Valid Contract

Now let us discuss the various essential elements of a valid contract.

In terms of Section 10 of the Act, "all agreements are contracts if they are made by the free consent of the parties competent to contract, for a lawful consideration and with a lawful object and are not expressly declared to be void".

Thus, in order to create a valid contract, the following elements should be present:

1. Intention to create legal obligation through offer and acceptance should be present.
2. Free consent of the parties is necessary.
3. Competency or capacity of parties to enter into contract must be ensured.
4. Lawful consideration & lawful object should be present, and
5. Agreement not expressly declared to be void.

The above important elements may be further analysed as under:

1. **Offer and Acceptance:** In the first place, there must be an offer and the said offer must have been accepted. Such offer and acceptance should create legal obligations between parties. This should result in a moral duty on the person who promises or offers to do something. Similarly this should also give a right to the promise to claim its fulfillment. Such duties and rights should be legal and not merely moral.

*Case law:*

In *Balfour v. Balfour*, a husband promised to pay maintenance allowance every month to his wife, so long as they remain separate. When he failed to perform this promise, she brought an action to enforce it. As it is an agreement of domestic nature, it was held that it does not contemplate to create any legal obligation.

2. **Consent:** The second element is the 'consent' of the parties. 'Consent' means 'knowledge and approval' of the parties concerned. This can also be understood as identity of minds in understanding the term viz consensus ad idem. Further such a consent must be free. Consent would be considered as free consent if it is not vitiated by coercion, undue influence, fraud, misrepresentation or mistake. Wherever the consent of any party is not free, the contract is voidable at the option of that party.

*Illustration:-* A threatened to shoot B if he (B) does not lend him ₹ 2000 and B agreed to it. Here the agreement is entered into under coercion and hence voidable at the option of B.

3. **Capacity of the parties:** The third element is the capacity of the parties to make a valid contract. Capacity or incapacity of a person could be decided only after reckoning various factors. Section 11 of the Indian Contract Act, 1872 elaborates on the issue by providing that a person who-

- (a) has not attained the age of majority,
- (b) is of unsound mind and
- (c) is disqualified from entering into a contract by any law to which he is subject,

should be considered as not competent to enter into any contract. Therefore law prohibits (a) Minors (b) persons of unsound mind [excluding the Lucid intervals] and (c) person who are otherwise disqualified like an alien enemy, insolvents, convicts etc from entering into any contract.

4. **Consideration:** The fourth element is presence of a lawful 'consideration'. 'Consideration' would generally mean 'compensation' for doing or omitting to do an act or deed. It is also referred to as '*quid pro quo*' viz 'something in return for another thing'. Such a consideration should be a lawful consideration.

*Example:-* A agrees to sell his books to B for ₹ 100, B's promise to pay ₹ 100 is the consideration for A's promise to sell his books and A's promise to sell the books is the consideration for B's promise to pay ₹ 100.

## 1.4 Business Law, Ethics and Communication

5. **Not expressly declared to be void:** The last element to clinch a contract is that the agreement entered into for this purpose must not be which the law declares to be either illegal or void. An illegal agreement is an agreement expressly or impliedly prohibited by law. A void agreement is one without any legal effects.

For *Example:* Threat to commit murder or making/publishing defamatory statements or entering into agreements which are opposed to public policy are illegal in nature. Similarly any agreement in restraint of trade, marriage, legal proceedings etc are classic examples of void agreements.

### Key Points

- ◆ An agreement enforceable by law is a contract. It creates legal obligations between the parties.
- ◆ Every promise and every set of promises forming consideration for each other is an agreement.
- ◆ An agreement comes into existence when one party accepts a proposal put forward by other. In other words, agreement is a promise which results from acceptance of a proposal. Thus agreement, a promise/set of promises is an accepted proposal.

## 1.3 Types of Contract

Now let us discuss various types of contracts



1. **Void Contract:** Section 2 (j) states as follows: "A contract which ceases to be

enforceable by law becomes void when it ceases to be enforceable". Thus a void contract is one which cannot be enforced by a court of law.

*Example :* Mr. X agrees to write a book with a publisher. After few days, X dies in an accident. Here the contract becomes void due to the impossibility of performance of the contract .

It may be added by way of clarification here that when a contract is void, it is not a contract at all but for the purpose of identifying it , it has to be called a [void] contract.

**2. Voidable Contract:** Section 2(i) defines that an agreement which is enforceable by law at the option of one or more parties but not at the option of the other or others is a voidable contract.

This infact means where one of the parties to the agreement is in a position or is legally entitled or authorized to avoid performing his part, then the agreement is treated and becomes voidable. Such a right might arise from the fact that the contract may have been brought about by one of the parties by coercion, undue influence, fraud or misrepresentation and hence the other party has a right to treat it as a voidable contract.

At this juncture it would be desirable to know the distinction between a void contract and a voidable contract. The distinctions lie in three aspects namely definition, nature and rights. These are elaborated hereunder:

(a) *Definition:* A void contract cannot be enforced at all. A voidable contract is an agreement which is enforceable only at the option of one of the parties but not at the option of the other. Therefore 'enforceability' or otherwise, divides the two types of contracts.

(b) *Nature:* By nature, a void contract is valid at the time when it is made but becomes unenforceable and thus void on account of subsequent developments or events like supervening impossibility, subsequent illegality etc., Repudiation of a voidable contract also renders the contract void. Similarly a contingent contract might become void when the occurrence of the event on which it is contingent becomes impossible.

On the other hand voidable contract would remain valid until it is rescinded by the person who has the option to treat it as voidable. The right to treat it as voidable does not invalidate the contract until such right is exercised. All contracts caused by coercion, undue influence, fraud, misrepresentation are voidable. Generally, a contract caused by mistake is void.

(c) *Rights:* As regards rights of the parties, in the case of a void contract there is no legal remedy for the parties as the contract cannot be performed in any way. In the case of voidable contract the aggrieved party has a right to rescind it within a reasonable time. If it is so rescinded, it becomes void. If it is not rescinded, it is a valid contract.

**3. Illegal Contract:** Illegal contract are those that are forbidden by law. All illegal contracts are hence void also. Because of the illegality of their nature they cannot be enforced by any court of law. In fact even associated contracts cannot be enforced. Contracts which are opposed to public policy or immoral are illegal. Similarly contracts to commit crime like supari contracts are illegal contracts.

The above discussion shows that illegal contracts are at par with void contracts. The Act specifies several factors which would render an agreement void. One such factor is unlawful nature of contract or the consideration meant for it. Though illegal agreements and void agreements appear similar they differ in the following manner:

- (a) *Scope*: All illegal agreements are void. However void agreements might not be illegal at the time of entering but would have become void because of some other factors. For example, where the terms of the agreement are uncertain the agreement would not be illegal but might be treated as void. An illegal contract would encompass a void contract where as a void contract may not include in its scope illegal contracts.
- (b) *Nature and character*: Illegal agreements are void since the very beginning they are invariably described as void ab initio. As already emphasized under the scope, a contract by nature, which is valid, can subsequently change its character and can become void.
- (c) *Effect on collateral transactions*: In the case of illegal contract, even the collateral transactions namely transactions which are to be complied with before or after or concurrently along with main contract also become not enforceable. In contrast in the case of voidable contracts the collateral transactions can be enforced despite the fact that the main contract may have become voidable, to the extent the collateral transactions are capable of being performed independently.
- (d) *Penalty or punishment*: All illegal agreements are punishable under different laws say like Indian Penal Code etc. Whereas parties to void agreements do not face such penalties or punishments.

Further classification of contracts according to the formation is also possible. Under this sub-classification the following contracts fall:

- 4. **Express Contracts**: A contract would be an express contract if the terms are expressed by words or in writing. Section 9 of the Act provides that if a proposal or acceptance of any promise is made in words the promise is said to be express.
- 5. **Implied Contracts**: Implied contracts in contrast come into existence by implication. Most often the implication is by law and or by action. Section 9 of the Act contemplates such implied contracts when it lays down that in so far as such proposal or acceptance is made otherwise than in words, the promise is said to be implied. For *instance* 'A' delivers goods by mistake at the warehouse of 'B' instead of that of 'C'. Here 'B' not being entitled to receive the goods is obliged to return the goods to 'A' although there was no such contract to that effect.
- 6. **Tacit Contracts**: Tacit contracts are those that are inferred through the conduct of parties. A classic *example* of tacit contract would be when cash is withdrawn by a customer of a bank from the automatic teller machine [ATM]. Another *example* of tacit contract is where a contract is assumed to have been entered when a sale is given effect to at the fall of hammer in an auction sale.

Further classification of contracts is possible on the basis of their performance. They are:

- 7. **Executed Contract**: The consideration in a given contract could be an act or

forbearance. When the act is done or executed or the forbearance is brought on record, then the contract is an executed contract.

**8. Executory Contract:** In an executory contract the consideration is reciprocal promise or obligation. Such consideration is to be performed in future only and therefore these contracts are described as executory contracts.

**9. Unilateral Contract:** Unilateral contract is a one sided contract in which only one party has to perform his duty or obligation.

**10. Bilateral Contract:** A Bilateral contract is one where the obligation or promise is outstanding on the part of both the parties.

Now let us take a look at yet another type of classification of contracts from the view point of English Law.

The English law classifies contracts as (i) Formal contracts and (ii) Simple contracts.

Formal contracts are further classified as (a) Contract of Record and (b) Contract under Seal.

**(a) Contract of Record:** A contract of record derives its binding force from the authority of court. The authority of court is invariably through judgment of a court or by way of recognizance. The judgment of a court is technically not a contract as it is not based on the agreement between parties. However the judgment is binding on all the persons who are litigants. The judgment creates certain rights on certain persons and obligation on certain other persons. A recognizance, on the other hand is a written acknowledgement of a debt due to the state generally in the context of criminal proceedings.

**(b) Contract under Seal:** A contract under seal is one which derives its binding force from its form alone. It is in writing, duly signed and sealed and delivered to parties. It is also referred to as a deed or a specialty contract.

Simple contracts as against formal contracts are devoid of all the formalities referred above.

#### Key Points

- ◆ Void agreement- Agreement not enforceable by law and is without any legal effect.
- ◆ Void contract- Valid at the time of making but becomes void subsequently due to change in circumstances.
- ◆ Voidable contract- Agreement enforceable at the option of the aggrieved party. Until the party won't nullify, it remains valid.
- ◆ Illegal agreement-An agreement prohibited or forbidden by law.
- ◆ Express contract-Where parties orally or written defines terms and conditions of the contract.
- ◆ Implied contract-Contract inferred from act, conduct or from the circumstances of the case.

- ◆ Executed contract- Which has been completely performed by all the parties.
- ◆ Executory contract- One in which something remains to be done by all the parties.
- ◆ Bilateral contracts- Where the obligations on the part of both the parties are outstanding at the time of formation of the contract.
- ◆ Unilateral contract- Where only one party has to perform his duty or obligation .

### 1.4 Proposal / Offer

It has been explained in the previous paragraphs that a proposal or a promise backed by legal consideration is an agreement and such an agreement, if legally enforceable, becomes a contract. It would therefore be clear that the starting point of this chain is a proposal or a promise. It is proposed now to discuss as to what is a proposal/offer, what are the types of offer, etc.

The word 'proposal' and the word 'offer' mean one and the same thing and therefore are used interchangeably. In terms of Section 2(a) of the Act "a person is said to make a proposal when he signifies to another his willingness to do or abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence". It must be appreciated that 'doing an act' and 'not doing an act' both have the same effect in the eyes of the law, though one is a positive act and the other is a negative act.

Hence there are two important ingredients to an offer. *Firstly*, it must be expressions of willingness to do or to abstain from doing an act. *Secondly*, the willingness must be expressed with a view to obtain the assent of the other party to whom the offer is made.

This can be *illustrated* as follows:

- (a) Where "A" tells "B" that he desires to marry 'B' by the end of 2006, there is no offer made unless, he also asks "will you marry me?", conveying his willingness and tries to obtain the assent of 'B' in the same breadth.
- (b) Where "A" offers to sell his car to "B" it conveys his willingness to do an act. Through this offer not only willingness is being conveyed but also an intention to obtain the assent can be seen.

**Classification of offer:** Offer can be classified as general offer, special/specific offer, cross offer, counter offer, standing/open/continuing offer. Now let us examine each one of them.

(a) *General offer:* It is an offer made to public at large with or without any time limit. In terms of Section 8 of the Act, anyone performing the conditions of the offer can be considered to have accepted the offer (*Carlill v. Carbolic Smoke Ball*). Until the general offer is retracted or withdrawn, it can be accepted by anyone at any time as it is a continuing offer.

(b) *Special/specific offer:* Where an offer is made to a particular and specified person, it is a specific offer. Only that person can accept such specific offer, as it is special and exclusive to him. [*Boulton v. Jones*]

(c) *Cross offer*: As per section 2(b), when a person to whom proposal (offer) is made signifies his assent, the proposal is said to be accepted. Thus, assent can be only to a 'proposal'. If there was no proposal, question of its acceptance cannot arise. For *example*, if A makes a proposal to B to sell some goods at a specified price and B, without knowing proposal of A, makes a proposal to purchase the same goods at the price specified in the proposal of A, it is not an acceptance, as B was not aware of proposal made by A. It is only cross proposal (cross offer). And when two persons make offer to each other, it can not be treated as mutual acceptance. There is no binding contract in such a case [*Tin v. Hoffmen & Co. 1873*]

(d) *Counter offer*: Upon receipt of an offer from an offeror, if the offeree instead of accepting it straightway, imposes conditions which have the effect of modifying or varying the offer, he is said to have made a counter offer. Counter offers amounts to rejection of original offer.

(e) *Standing or continuing or open offer*: An offer which is made to public at large and if it is kept open for public acceptance for a certain period of time, it is known as standing or continuing or open offer. Tenders that are invited for supply of materials and goods are classic examples of standing offer.

**Rules relating to offer:** Following are the rules for a valid and legal offer:

- (a) The 'offer' must be with *intent to create a legal relationship*. Hence if it is accepted, it must result in a valid contract. An invitation to join a friend for dinner is a social activity. This does not create a legal relationship or right or obligation.
- (b) The offer must be *certain and definite*. It must not be vague. If the terms are vague, it is not capable of being accepted as the vagueness would not create any contractual relationship. For *example*, where 'A' offers to sell 100 litres of oil, without indicating what kind of oil would be sold, it is a vague offer and hence cannot create any contractual relationship. If however there is a mechanism to end the vagueness, the offer can be treated as valid. For *example*, in the above example if 'A' does not deal in any oil but only in gingilee oil and this is known to every one, the offer cannot be treated as vague offer. This is for the reason that the trade in which 'A' is, is a clear indicator providing a mechanism to understand the terms of offer.
- (c) The offer must be *express or implied*.
- (d) The offer must be *distinguished from an invitation to offer*.
- (e) The offer must be *either specific or general*.
- (f) The offer must be *communicated* to the person to whom it is made. Otherwise the offeree cannot accept the offer. He cannot accept the offer because he is not aware of the existence of the offer. Such a situation does not create any legal obligation or right on any one.
- (g) The offer must be made with a view *to obtaining the consent of the offeree*.
- (h) An offer can be *conditional* but there should be no term in the offer that non-compliance



would amount to acceptance. Thus the offeror cannot say that if non-acceptance is not communicated by a certain time the offer would be treated as accepted.

#### **What is invitation to offer?**

An offer and invitation to offer are not one and the same. The difference between the two must be appreciated. An offer is definite. It is an intention towards a contract. An invitation to offer is an act precedent to making an offer. It is done with intent to generally to induce and negotiate. An invitation to offer gives rise to an offer after due negotiation and it cannot be per se accepted.

In an invitation to offer there is no expression of willingness by the offeror to be bound by his offer. It is only a proposal of certain terms on which he is willing to negotiate. It is not capable of being accepted as it is.

When there is advertisement by a person he has a stock of books for sale, it is an invitation to offer and not an offer. This advertisement is made to receive offers and to further negotiate.

In terms of Section 2[a] of the Act, it is very clear that an offer is the final expression of willingness by the offeror to be bound by the offer if it is accepted by the other party. Hence the only thing that is required is the willingness of the offeree to abide by the terms of offer.

The test to decide whether a statement is an 'offer' or 'invitation to offer' is to see the 'intention'. If a person who makes the statement has the intention to be bound by it as soon as the other accepts, he is making an offer. If he however intends to do some other act, he is making only an invitation to offer. Thus the intention to be bound is the important thing, which is to be seen.

In *Harvey vs. Face [1893] AC 552* Privy Council succinctly explained the distinction between an offer and an invitation to offer. In the given case, the plaintiffs through a telegram asked the defendants two questions namely,

- (i) Will you sell us Bumper Hall Pen? and
- (ii) Telegraph lowest cash price.

The defendants replied through telegram that the "lowest price for Bumper Hall Pen is £900". The plaintiffs sent another telegram stating "we agree to buy Bumper Hall Pen at £900..." However the defendants refused to sell the property at the price.

The plaintiffs sued the defendants contending that they had made an offer to sell the property at £900 and therefore they are bound by the offer.

However the Privy Council did not agree with the plaintiffs on the ground that while plaintiffs had asked two questions, the defendant replied only to the second question by quoting the price but did not answer the first question but reserved their answer with regard to their willingness to sell. Thus they made no offer at all. Their Lordships held that the mere statement of the lowest price at which the vendor would sell contained no implied contract to sell to the person who had enquired about the price.

The above decision was followed in *Mac Pherson vs Appanna [1951] A.S.C. 184* where the owner of the property had said that he would not accept less than ₹ 6000/- for it. This statement did not indicate any offer but indicated only an invitation to offer.

Similarly when goods are sold through auction, the auctioneer does not contract with any one who attends the sale. The auction is only an advertisement to sell but the items are not put for sale though persons who have come to the auction may have the intention to purchase.

Following are *instances* of invitation to offer to buy or sell:

- (i) An invitation by a company to the public to subscribe for its shares.
- (ii) Display of goods for sale in shop windows.
- (iii) Advertising auction sales and
- (iv) Quotation of prices sent in reply to a query regarding price.

#### Key Points

- ◆ Offer-An expression of willingness of offeror to an offeree to do or to abstain from doing anything, with a view to obtain the assent of an offeree and to enter him into a contract.
- ◆ Agreement-An accepted offer/proposal
- ◆ Promisor- Person making the proposal.
- ◆ Promisee- Person accepting the proposal
- ◆ Express Offer-Expressed by written/spoken words
- ◆ Implied offer-Expressed other than in written /spoken words
- ◆ Specific offer-Offer made to a specific person
- ◆ General offer-Offer made to the public at large
- ◆ Cross offers- Identical offers made in ignorance to each other.
- ◆ Counter offers- Offer accepted on the terms and conditions other than set out by the offeror.
- ◆ Standing offer- Offer open for acceptance over period of time.
- ◆ Legal rules for valid offer-Definite and certain, made with an intention to create legal relations and must be communicated.
- ◆ Invitation to an offer-One party invites other party to make an offer i.e., an offer to make an offer.

### 1.5 Acceptance

The significance of “acceptance of a proposal” so as to form an agreement has been discussed in previous paragraphs. Let us analyse various issues concerning ‘acceptance’ now,

Meaning: In terms of Section 2(b) of the Act, "A proposal or offer is said to have been accepted when the person to whom the proposal is made signifies his assent to the proposal to do or not to do something". In short, act of acceptance lies in signifying one's assent to the proposal.

**Relationship between offer and acceptance:** According to Sir William Anson "*Acceptance is to offer what a lighted match is to a train of gun powder*". The effect of this observation is that what acceptance triggers cannot be recalled or undone. But there is a choice to the person who had the train to remove it before the match is applied. It in effect means that the offer can be withdrawn just before it is accepted. Acceptance converts the offer into a promise and then it is too late to revoke it. This means as soon as the train of gun powder is lighted it would explode. Gun powder [the train] itself is inert, but it is the lighted match [the acceptance] which causes the gun powder to explode. The significance of this is an offer by itself cannot create any legal relationship but it is the acceptance by the offeree which creates a legal relationship. Once an offer is accepted it becomes a promise and cannot be withdrawn or revoked. An offer remains an offer so long as it is not accepted, but becomes a contract as soon as it is accepted.

#### **Rules governing acceptance**

(1) *Acceptance must be absolute and unqualified:* As per section 7 of the Act, acceptance is valid only when it is absolute and unqualified and is also expressed in some usual and reasonable manner unless the proposal prescribes the manner in which it must be accepted. If the proposal prescribes the manner in which it must be accepted, then it must be accepted accordingly. The above view will be clear from the following *example*:

'A' enquires from 'B', "Will you purchase my car for ₹ 2 lakhs?" If 'B' replies "I shall purchase your car for ₹ 2 lakhs, if you buy my motorcycle for ₹ 50000/-, here 'B' cannot be considered to have accepted the proposal. If on the other hand 'B' agrees to purchase the car from 'A' as per his proposal subject to availability of valid Registration Certificate / book for the car, then the acceptance is in place though the offer contained no mention of R.C. book. This is because expecting a valid title for the car is not a condition. Therefore the acceptance in this case is unconditional.

(2) *The acceptance must be communicated:* To conclude a contract between the parties, the acceptance must be communicated in some perceptible form. Any conditional acceptance or acceptance with varying or too deviant conditions is no acceptance. Such conditional acceptance is a counter proposal and has to be accepted by the proposer, if the original proposal has to materialize into a contract. Further when a proposal is accepted, the offeree must have the knowledge of the offer made to him. If he does not have the knowledge, there can be no acceptance. The acceptance must relate specifically to the offer made. Then only it can materialize into a contract. The above points will be clearer from the following *examples*,

(a) M offered to sell his land to N for £ 280. N replied purporting to accept the offer but enclosed a cheque for £ 80 only. He promised to pay the balance of £ 200 by monthly installments of £ 50 each. It was held that N could not enforce his acceptance because it was not an unqualified one. [*Neale vs. Merret [1930] W. N. 189*].

- (b) A offers to sell his house to B for ₹ 1000/-. B replied that, "I can pay ₹ 800 for it. The offer of 'A' is rejected by 'B' as the acceptance is not unqualified. B however changes his mind and is prepared to pay ₹ 1000/-. This is also treated as counter offer and it is upto A whether to accept it or not. [*Union of India v. Bahulal AIR 1968 Bombay 294*].

A mere variation in the language not involving any difference in substance would not make the acceptance ineffective. [*Heyworth vs. Knight [1864] 144 ER 120*].

(3) *Acceptance must be in the prescribed mode:* Where the proposal prescribes the mode of acceptance, it must be accepted in that manner. Where the proposal does not prescribe the manner, then it must be accepted in a reasonable manner. If the proposer does not insist on the proposal being accepted in the manner in which it has to be accepted, after it is accepted in any other manner not originally prescribed, the proposer is presumed to have consented to the acceptance. Sometimes the acceptor may agree to a proposal but may insist on a formal agreement, in which case until a formal agreement is drawn up there is no complete acceptance.

(4) *The acceptance must be given within a reasonable time and before the offer lapses.*

(5) *Mere silence is not acceptance.* The acceptor should expressly accept the offer. Acceptance can be implied also. Acceptance must be given only by that person to whom it is made, that too only after knowing about the offer made to him.

(6) *Acceptance by conduct:* As already elaborated above, acceptance has to be signified either in writing or by word of mouth or by performance of some act. The last of the method, namely 'by some act' has to be understood as acceptance by conduct. In a case like this where a person performs the act intended by the proposer as the consideration for the promise offered by him, the performance of the act constitutes acceptance. In other words, there is an acceptance by conduct.

For *example*, where a tradesman receives an order from a customer, and the order is executed accordingly by the trader, there is an "acceptance by conduct" of the offer made by the customer. The trader's subsequent act signifies acceptance.

Section 8 of the Act very clearly in this regard lays down that " the performance of the condition(s) of a proposal or the acceptance of any consideration of a reciprocal promise which may be offered with a proposal constitutes an acceptance of the proposal.

#### Key Points

- ◆ Acceptance- Assent of offeree to a proposal. On acceptance of proposal, proposer is called as promisor and offeree as promisee.
- ◆ Acceptance is irreversible as once it is given and reaches to the proposer it cannot be recalled,
- ◆ Rules for valid acceptance- It must be absolute and unqualified, communicated, and must be in the prescribed mode and given within a reasonable time.

## 1.6 Communication of Offer and Acceptance

The importance of 'offer' and 'acceptance' in giving effect to a valid contract was explained in the previous paragraphs. One important common requirement for both 'offer' and 'acceptance' is their effective communication. Effective and proper communication prevents avoidable revocation and misunderstanding between parties. The communication part of it assumes importance because parties are separated by and distance. In which case the modes of communication like, post/courier, telegram, fax, email, telephone etc., become very relevant because the method of communication would also decide the 'time' of 'offer' and 'acceptance'. The Indian Contract Act, 1872 gives a lot of importance to "time" element in deciding when the offer and acceptance is complete.

**Communication of offer:** In terms of Section 4 of the Act, "the communication of offer is complete when it comes to the knowledge of the person to whom it is made". Therefore knowledge of communication is of relevance. Knowledge of the offer would materialize when the offer is given in writing or made by word of mouth or by some other conduct. This can be explained by an *example*. Where 'A' makes a proposal to 'B' by post to sell his house for ₹ 5 lakhs and if the letter containing the offer is posted on 10<sup>th</sup> March and if that letter reaches 'B' on 12<sup>th</sup> March the offer is said to have been communicated on 12<sup>th</sup> March when B received the letter. Thus it can be summed up that when a proposal is made by post, its communication will be complete when the letter containing the proposal reaches the person to whom it is made.

**Communication of acceptance:** There are two issues for discussion and understanding. They are: what are the modes of acceptance and when is acceptance complete?

Let us, first consider the *modes of acceptance*. Section 3 of the Act prescribes in general terms two modes of communication namely, (a) by any act and (b) by omission, intending thereby to, to communicate to the other or which has the effect of communicating it to the other.

Communication by act would include any expression of words whether written or oral. Written words will include letters, telegrams, faxes, emails and even advertisements. Oral words will include telephone messages. Again communication would include any conduct intended to communicate like positive acts or signs so that the other person understands what the person 'acting' or 'making signs' means to say or convey.

Communication can also be by 'omission' to do any or something. Such omission is conveyed by a conduct or by forbearance on the part of one person to convey his willingness or assent. However silence would not be treated as communication by 'omission'.

Communication of acceptance is also done by conduct. For *instance*, delivery of goods at a price by a seller to a willing buyer will be understood as a communication by conduct to convey acceptance. Similarly one need not explain why one boards a public bus or drop a coin in a weighing machine. The first act is a conduct of acceptance and its communication to the offer by the public transport authority to carry any passenger. The second act is again a conduct conveying acceptance to use the weighing machine kept by the vending company as

an offer to render that service for a consideration.

The other issue in communication of acceptance is about the effect of act or omission or conduct. These indirect efforts must result in effectively communicating its acceptance or non acceptance. If it has no such effect, there is no communication regardless of which the acceptor thinks about the offer within himself. Thus a mere mental unilateral assent in one's own mind would not amount to communication. Where a resolution passed by a bank to sell land to 'A' remained uncommunicated to 'A', it was held that there was no communication and hence no contract. [*Central Bank Yeotmal vs Vyankatesh (1949) A. Nag. 286*].

Let us now come to the issue of *when communication of acceptance is complete*. In terms of Section 4 of the Act, it is complete,

- (i) As against the proposer, when it is put in course of transmission to him so as to be out of the power of the acceptor to withdraw the same;
- (ii) As against the acceptor, when it comes to the knowledge of the proposer.

Where a proposal is accepted by a letter sent by the post, the communication of acceptance will be complete as against the proposer when the letter of acceptance is posted and as against the acceptor when the letter reaches the proposer. For *instance* in the above *example*, if 'B' accepts, A's proposal and sends his acceptance by post on 14<sup>th</sup>, the communication of acceptance as against 'A' is complete on 14<sup>th</sup>, when the letter is posted. As against 'B' acceptance will be complete, when the letter reaches 'A'. Here 'A' the proposer will be bound by B's acceptance, even if the letter of acceptance is delayed in post or lost in transit. The golden rule is proposer becomes bound by the contract, the moment acceptor has posted the letter of acceptance. But it is necessary the letter is correctly addressed, sufficiently stamped and duly posted. In such an event the loss of letter in transit, wrong delivery, non delivery etc., will not affect the validity of the contract. However from the view point of acceptor, he will be bound by his acceptance only when the letter of acceptance has reached the proposer. So it is crucial in this case that the letter reaches the proposer. If there is no delivery of the letter, the acceptance could be treated as having been completed from the viewpoint of proposer but not from the viewpoint of acceptor. Of course this will give rise to an awkward situation of only one party to the contract being treated as bound by the contract though no one would be sure as to where the letter of acceptance had gone.

**Communication of special conditions:** Sometimes there are situations where there are contracts with special conditions. These special conditions are conveyed tacitly and the acceptance of these conditions are also conveyed by the offeree again tacitly or without him even realizing it.

For *instance* where a passenger undertakes a travel, the conditions of travel are printed at the back of the tickets, sometimes these special conditions are brought to the notice of the passenger, sometimes not. In any event, the passenger is treated as having accepted the special condition the moment he bought his ticket.

When someone travels from one place to another by air, it could be seen that special

conditions are printed at the back of the air ticket in small letters [in a non computerized train ticket even these are not printed] Sometimes these conditions are found to have been displayed at the notice board of the Air lines office, which passengers may not have cared to read. The question here is whether these conditions can be considered to have been communicated to the passengers of the Airlines and can the passengers be treated as having accepted the conditions. The answer to the question is in the affirmative and was so held in *Mukul Datta vs. Indian Airlines* [1962] AIR cal. 314 where the plaintiff had travelled from Delhi to Kolkata by air and the ticket bore conditions in fine print.

Yet another *example* is where a launderer gives his customer a receipt for clothes received for washing. The receipt carries special conditions and are to be treated as having been duly communicated to the customer and therein a tacit acceptance of these conditions is implied by the customer's acceptance of the receipt [*Lily White vs. R. Muthuswami* [1966] A. Mad. 13].

In the cases referred above, the respective documents have been accepted without a protest and hence amounted to tacit acceptance.

**Standard forms of contracts:** It is well established that a standard form of contract may be enforced on another who is subjectively unaware of the contents of the document, provided the party wanting to enforce the contract has given notice which, in the circumstances of a case, is sufficiently reasonable. But the acceptor will not incur any contractual obligation, if the document is so printed and delivered to him in such a state that it does not give reasonable notice on its face that it contains certain special conditions. In this connection, let us consider a converse situation. A transport carrier accepted the goods for transport without any conditions. Subsequently, he issued a circular to the owners of goods limiting his liability for the goods. In such a case, since the special conditions were not communicated prior to the date of contract for transport, these were not binding on the owners of goods [*Raipur transport Co. vs. Ghanshyam* [1956] A. Nag. 145].

## 1.7 Communication of Performance

We have already discussed that in terms of Section 4 of the Act, communication of a proposal is complete when it comes to the knowledge of the person to whom it is meant. As regards acceptance of the proposal, the same would be viewed from two angles. These are (i) from the viewpoint of proposer and (ii) the other from the viewpoint of acceptor himself. From the viewpoint of proposer, when the acceptance is put in to a course of transmission, when it would be out of the power of acceptor. From the viewpoint of acceptor, it would be complete when it comes to the knowledge of the proposer.

At times the offeree may be required to communicate the performance (or act) by way of acceptance. In this case it is not enough if the offeree merely performs the act but he should also communicate his performance unless the offer includes a term that a mere performance will constitute acceptance. The position was clearly explained in the famous case of *Carlill Vs Carbolic & Smokeball Co.* In this case the defendant a sole proprietary concern manufacturing a medicine which was a carbolic ball whose smoke could be inhaled through the nose to cure

influenza, cold and other connected ailments issued an advertisement for sale of this medicine. The advertisement also included a reward of \$100 to any person who contracted influenza, after using the medicine (which was described as 'carbolic smoke ball'). Mrs. Carlill bought these smoke balls and used them as directed but contracted influenza. It was held that Mrs Carlill was entitled to a reward of \$100 as she had performed the condition for acceptance. Further as the advertisement did not require any communication of compliance of the condition, it was not necessary to communicate the same. The court thus in the process laid down the following three important principles:

- (i) an offer, to be capable of acceptance, must contain a definite promise by the offer or that he would be bound provided the terms specified by him are accepted;
- (ii) an offer may be made either to a particular person or to the public at large, and
- (iii) if an offer is made in the form of a promise in return for an act, the performance of that act, even without any communication thereof, is to be treated as an acceptance of the offer.

#### Key Points

- ◆ One important common requirement for both 'offer' and 'acceptance' is their effective communication. The Indian Contract Act, 1872 gives a lot of importance to "time" element in deciding when the offer and acceptance is complete.
- ◆ Communication of offer is complete- When it comes to the knowledge of the person to whom it is made.
- ◆ Communication of acceptance is complete- (i) Against the proposer-when it is put into the course of transmission to the proposer.(ii) Against the acceptor—when it comes to the knowledge of the offeror.

### 1.8 Revocation of Offer and Acceptance

If there are specific requirements governing the making of an offer and the acceptance of that offer, we also have specific law governing their revocation.

In term of Section 4, communication of revocation (of the proposal or its acceptance) is complete.

- (i) as against the person who makes it when it is put into a course of transmission to the person to whom it is made so as to be out of the power of the person who makes it, and
- (ii) as against the person to whom it is made, when it comes to his knowledge.

**The above law can be *illustrated* as follows:-** If you revoke your proposal made to me by a telegram, the revocation will be complete, as far as you are concerned when you have dispatched the telegram. But as far as I am concerned, it will be complete only when I receive the telegram.

As regards revocation of acceptance, if you go by the above example, I can revoke my acceptance



(of your offer) by a telegram. This revocation of acceptance by me will be complete when I dispatch the telegram and against you, it will be complete when it reaches you.

But the important question for consideration is when a proposal can be revoked? And when can an acceptance be revoked?. These questions are more important than the question when the revocation (of proposal and acceptance) is complete.

In terms of Section 5 of the Act a proposal can be revoked at any time before the communication of its acceptance is complete as against the proposer. An acceptance may be revoked at any time before the communication of acceptance is complete as against the acceptor.

**Revocation of proposal otherwise than by communication:** When a proposal is made, the proposer may not wait indefinitely for its acceptance. The offer can be revoked otherwise than by communication or sometimes by lapse.

**Following are the situations worth noting in this regard**

(i) *When the acceptor fails to fulfill certain conditions precedent to acceptance:-* Where the acceptor fails to fulfill a condition precedent to acceptance the proposal gets revoked. This principle is laid down in Section 6 of the Act. The offeror for instance may impose certain conditions such as executing a certain document or depositing certain amount as earnest money. Failure to satisfy any condition will result in lapse of the proposal. As stated earlier 'condition precedent' to acceptance prevents an obligation from coming into existence until the condition is satisfied. Suppose where 'A' proposes to sell his house to be 'B' for ₹ 5 lakhs provided 'B' leases his land to 'A'. If 'B' refuses to lease the land, the offer of 'A' is revoked automatically.

(ii) *When the proposer dies or goes insane:* Death or insanity of the proposer would result in automatic revocation of the proposal but only if the fact of death or insanity comes to the knowledge of the acceptor

(iii) *When time for acceptance lapses:* The time for acceptance can lapse if the acceptance is not given within the specified time and where no time is specified, then within a reasonable time. This is for the reason that proposer should not be made to wait indefinitely. It was held in *Ramsgate Victoria Hotel Co Vs Montefiore* (1866 L.R.Z. Ex 109), that a person who applied for shares in June was not bound by an allotment made in November. This decision was also followed in *India Cooperative Navigation and Trading Co Ltd Vs Padamsey Prem Ji*. However these decisions now will have no relevance in the context of allotment of shares since The Companies Act, 1956 has several provisions specifically covering these issues.

#### **Key Points**

Communication of revocation as against the person who makes it, completes- when it is put into the course of transmission to the person to whom it is made

- ◆ Communication of revocation as against the person to whom it is made, completes- when it comes to his knowledge.
- ◆ Revocation of proposal and acceptance is complete- at any time before the communication of proposal and acceptance is complete as against the proposer and the acceptor, but not afterwards.

## UNIT-2 : CONSIDERATION

### Learning objectives

After studying this unit, you would be able to -

- ◆ Understand the concept of consideration, its importance for a contract and its double aspect.
- ◆ Clearly understand how consideration may move from a third party and how this makes the contract valid.
- ◆ Learn about the peculiar circumstances when a contract is valid even without consideration.
- ◆ Be aware of the rule 'A stranger to a contract cannot sue' and exceptions thereof.

In the previous unit we learnt that one of the important elements of contract is "consideration". In this unit the concept of consideration and the legal requirements for consideration are discussed.

### 1.9 What is Consideration?

The expression 'consideration' has to be understood as a price paid for an obligation. In *Curie Vs Misa (1875) LR 10 Ex 153* it was held (in U K) that consideration is "some right, interest, profit or benefit accruing to one party or forbearance, detriment, loss, or responsibility given, suffered or undertaken by the other". The judgment thus refers to the position of both the promisor, and the promisee in an agreement.

Section 2 (d) of the Indian Contract Act, 1872 defines consideration as '*when at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing or promises to do or abstain from doing something, such an act or abstinence or promise is called consideration for the promise*'.

From the above definition it can be inferred that,

Consideration is doing or not doing something, which the promisor desires to be done or not done.

- (1) Consideration must be at the desire of the promisor.
- (2) Consideration may move from one person to any other person
- (3) Consideration may be past, present or future and
- (4) Consideration should be real though not adequate

In most cases the promisor for doing an act or not doing an act derives some benefit by way of consideration. Thus consideration is identified as *quid pro quo* from the promise or performance of the promisor.

But it is also possible that there may not be any identifiable benefit towards consideration. For example 'A' promises to carry 'B's goods free of charge and B allows 'A' to carry the same. Here 'B' does not offer any consideration to 'A'. Is this a valid contract?

The answer to the question is 'B' has suffered a detriment or disadvantage while allowing 'A' to carry his goods. Here there is sufficient consideration. This illustration is given essentially to prove the point that consideration could be not necessarily a gain or advantage to the promisor but it can even be a loss or detriment to the promisee. That is why 'consideration' is referred to as a concept with 'double aspect'.

Where Y applies for a loan of ₹ 10,000/- to X, and if 'X' insists on a guarantee by 'S' and upon 'S' guaranteeing the loan, 'X' gives the loan to 'Y'. In this case 'S' will be the promisor and 'X' the promisee. The benefit in this transaction conferred on 'Y' by 'X' at the guarantee of 'S', is sufficient consideration for X. In other words 'X' has suffered a detriment which is the consideration for the guarantee of 'S' to repay the loan which 'X' has given to 'Y'. Detriment to one is benefit to another.

It can often be seen that consideration is mutual. For *instance* if 'A' promises to sell his house to 'B' for ₹ 5 lakhs, here "A" is the promisor and "B" is the promisee. In the same transaction where 'B' agrees to buy the house for ₹ 5 lakhs, 'B' will be the promisor and 'A' will be the promisee. Here 'A' must part with the house and 'B' must part with ₹ 5 lakhs. This proves the point that consideration is mutual and has two sides.

Thus from above it can be concluded that :

Consideration = Promise / Performance that parties exchange with each other.

Form of consideration= Some benefit, right or profit to one party / some detriment, loss, or forbearance to the other.

#### **Whether gratuitous promise can be enforced?**

The word "gratuitous" means 'free of cost' or 'without expecting any return'. It can therefore be inferred that a gratuitous promise will not result in an agreement in the absence of consideration. For *instance* a promise to subscribe to a charitable cause cannot be enforced.

### **1.10 Legal Requirements Regarding Consideration**

(i) **Consideration must move at the desire of the promisor:** Consideration must move at the desire of the promisor, either from the promisee or some other third party. But consideration cannot move at the desire of a third party. Where collector had passed an order that any one using the market constructed by the Zamindar, for the purpose of selling his goods should pay commission to the Zamindar, it was held that it was not a proper order as the desire to receive consideration had not emanated from the Zamindar but from a third party namely the collector [*Durga Prasad Vs Baldev (1880) 3, All 221*]

(ii) **Consideration can flow either from the promisee or any other person:** The consideration for a contract can move either from the promisee or from any other person. This point is made clear even by the definition of the word "consideration", according to which at the desire of the promisor, the promisee or any other person, doing something is consideration.

That the consideration can legitimately move from a third party is an accepted principle of law in India though not in England. *Example:* 'A' by a deed of gift made over certain property to

her daughter(D) with condition that her brother(B) should be paid annuity by D. On the same day, D executed a document agreeing to pay annuity accordingly but declined to pay after sometime. B sued D. It was contended on behalf of D, that there was no consideration from B and hence there was no valid contract. This plea was rejected on the ground that the consideration did flow from B's Sister(A) to 'D' and such consideration from third party is sufficient to enforce the promise of D to pay annuity to A's brother (B) [*Chinnaya Vs Ramaya(1881) 4.mad.137*]

Thus a stranger to a contract can sue upon a contract in India and also in England, where as stranger to a consideration can sue under Indian law though not under English law.

**(iii) Executed and Executory consideration:** Where consideration consists of performance, it is called "executed" consideration. Where it consists only of a promise, it is executory. For example where A pays ₹ 5000/- to 'B' requesting 'B' to deliver certain quantity of rice, to which B agrees, then here consideration for B is executed by 'A' as he has already paid ₹ 5000/- whereas 'B's promise is executory as he is yet to deliver the rice.

Insurance contracts are of the same type. When A pays a premium of ₹ 5000/- seeking insurance cover for the year, from the insurance company which the company promises in the event of fire, the consideration paid by A to the insurance company is executed but the promise of insurance company is executory or yet to be executed. A forbearance by the promisor should however be considered as an executed consideration provided the forbearance is sufficient at the time of contract.

**(iv) Past consideration:** The next issue is whether past consideration can be treated as consideration at all. This is because consideration is given and accepted along with a promise concurrently. However the Act recognizes past consideration as consideration when it uses the expression in Section 2(d) 'has done or abstained from doing". But in the event of services being rendered in the past at the request or desire of the promisor the subsequent promise is regarded as an admission that the past consideration was not gratuitous. The plaintiff rendered services to the defendant at his desire during his minority. He also continued to render the same services after the dependant attained majority. It was held to be good consideration for a subsequent express promise by the defendant to pay an annuity to the plaintiff but it was admitted that if the services had not been rendered at the desire of the defendant it would be hit by section 25 of the Act. [*Sindia Vs Abraham (1985)Z. Bom 755*]

**(v) Adequacy of Consideration:** Consideration need not necessarily be of the same value as of the promise for which it is exchanged. But it must be something which can be inadequate as well. Inadequate consideration would not invalidate an agreement but such inadequate consideration could be taken into account by the court in deciding whether the consent of the promisor was freely given.

In *Chijitumal Vs. Rampal Singh* AIR, 1968, the Supreme Court reiterated that consideration need not be material and may be even absent. In the said case, the father had died leaving his house to two sons. They had agreed to partition the house which did not admit the division in exactly equal parts and one of the sons had agreed not to construct a door at a certain place in his portion of the house. In a dispute, the agreement was challenged on the ground

## 1.22 Business Law, Ethics and Communication

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that it was without adequate consideration. The Supreme Court came to the conclusion that the motive for the said agreement at the time when it was made, was to avoid any dispute in future, and held that it was sufficient consideration.

The above view is in tune with explanation 2 to section 25 of the Act, which provides that an agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate. Where there is valuable consideration, Court will not interfere and inquire into the adequacy of it but leave the matter to the parties to make their own bargain. But inadequate consideration might raise suspicion about the free will of the promisor. Promisor could be treated as victim of some imposition but this would not render the agreement void.

**(vi) Performance of what one is legally bound to perform:** The performance of an act by a person what he is legally bound to perform, the same cannot be consideration for a contract. Hence, a promise to pay money to a witness is void, for it is without consideration. Hence such a contract is void for want of consideration. Similarly, an agreement by a client to pay to his counsel, a certain sum over and above the fee, in the event of success of the case would be void, since it is without consideration.

But where a person promises to do more than he is legally bound to do, such a promise provided it is not opposed to public policy, is a good consideration. For *instance* during a civil strike, a question arose as to how best to protect a coal mine. The police authorities thought that surveillance by a mobile force would be adequate but the colliery manager desired a stationary police guard. Ultimately it was agreed that the police authorities would provide a stationary guard and the manager would pay \$2,200 for the service. It was held that the promise to pay the amount was not without consideration. The police, no doubt, were bound to afford protection, but they had discretion as to the form it should take. The undertaking to provide more protection than what they deemed to be necessary was a consideration for the promise of reward. [*Classbrook Brothers vs. Glamorgan Country Council (19250) A.C.270*]

**(vii) Consideration must not be unlawful, immoral, or opposed to public policy.**

### 1.11 Suit by a Third Party to an Agreement

There is a big difference between a third party to consideration and third party to a contract; while the first can sue, the second cannot sue. Thus a stranger / third Party to an Agreement lead to the doctrine of privity of contract. The doctrine says that only parties to a contract can enforce the contract. The parties stranger to a contract cannot sue and be sued. *Example*, a contract by the purchaser of a mortgaged property to pay off the mortgage cannot be enforced by the mortgagee who was not a party to the contract between vendor and vendee.

However there are *exceptions* to the above principle. These are:

1. In the case of *a trust*, the beneficiary can sue enforcing his right though he was not a party to the contract between the trustee and the settler. In *Khawja Mohammed Khan Vs Hussain Begum* 371.A. 152, where, the father of the bridegroom promised to pay through a contract with the father of the bride, an allowance to the bride, if she married his son, the bride sued her father-in-law after marriage for the allowance which he did not pay as

per the contract. It was held by the Privy Council that though the bride was not a party to the contract between her father and father in law, she could enforce her claim in equity.

2. In the case of *family settlement*, if the terms of settlement are reduced in writing, members of the family who were not a party to the settlement can (also) enforce their claim. (*Shuppu Vs Subramanian 33 Mad.238*)
3. In the case of certain *marriage contracts* a female member can enforce a provision for marriage expense based on a petition made by the Hindu undivided family (*Sunder Raja Vs Lakshmi 38. Mad 788*).
4. Where there is an *assignment of a contract*, the assignee can enforce the contract for various benefits that would accrue to him on account of the assignment. [*Krishanlal Sadhu Vs Primila Bala Dasi (1928) Cal.1315*]
5. In case of *part performance of a contractual obligations* or where there is *acknowledgment of liability* on account of estoppel, a third party can sue for benefits. Where for *example* 'A' gives ₹ 25000/- to 'B' to be given to 'C' and 'B' informs 'C' that B is holding it on behalf of C, but subsequently refuses to pay 'C' then 'C' can sue and enforce his claim.
6. Where a piece of land which is sold to buyer with certain *covenants relating to land* and the buyer is kept on notice of the covenants with certain duties, there the successors to the seller can enforce these covenants.

## 1.12 Validity of an Agreement without Consideration

We have all along learnt that an agreement without consideration is void. Not only that, even inadequate consideration would render the enforceability of the contract quite difficult as the free consent of the parties would become suspect. The Act however contains certain exceptions to this important rule. These are:

- (i) **On account of natural love and affection:** A written and a registered agreement made between parties out of natural love and affection does not require consideration. Such an agreement is enforceable even without consideration. It is important that parties should be of near relation like husband and wife to get this exemption (*Rajlukhee Devee Vs Bhootnath*).
- (ii) **Compensation paid for past voluntary services:** A promise to compensate wholly or in part for past voluntary services rendered by someone to promisor does not require consideration for being enforced. However the past services must have been rendered voluntarily to the promisor. Further the promisor must have been in existence at that time and he must have intended to compensate.
- (iii) **Promise to pay debts barred by limitation:** Where there is a promise in writing to pay a debt, which was barred by limitation, is valid without consideration.
- (iv) **Creation of Agency:** In term of section 185 of the Act, no consideration is necessary to create an agency

(v) **In case of completed gifts, no consideration is necessary.** This is clear from the Explanation (1) to section 25 of the Act which provides that “nothing in this Section shall affect the validity as between donor and donee of any gift actually made.

**Key Points**

- ◆ Consideration- The promise/performance that parties exchange with each other.
  - ◆ Rules of valid consideration: Move at the desire of promisor by promisee and any other person. It must be for every contract though not necessarily be adequate but must be real and not illusory and should be of some value in terms of money.
- Contract without consideration is void subject to certain exceptions- agreement on account of natural love and affection, promise to compensate for voluntary services and promise to pay a time-barred debt, gift actually made, and in agency.

### UNIT – 3 : OTHER ESSENTIAL ELEMENTS OF A CONTRACT

#### Learning objectives

After studying this unit, you would be able to -

- ◆ Note the various ingredients of incapacity to contract.
- ◆ Be clear about the legal consequence of contracting with a minor.
- ◆ Be familiar with the concept of 'consensus ad idem' i.e. parties agreeing upon the same thing in the same sense.
- ◆ Try to grasp the characteristics of different elements vitiating free consent and particularly to distinguish amongst fraud, misrepresentation and mistake.
- ◆ Understand the circumstances when object and consideration become unlawful.
- ◆ Be aware of the agreements opposed to public policy.

In the previous units we discussed all aspects of offer, acceptance, revocation, and consideration. In this unit we will discuss other elements, which would constitute a contract.

We have earlier seen that in terms of section 10 of the Indian Contract Act, 1872 a legally enforceable agreement should be made with the free consent of the parties who are competent to contract for a lawful consideration with a lawful object. Further the agreement should not have been expressly declared as void by law. These elements would be examined hereunder.

#### 1.13 Free Consent

In terms of section 13 of the Act, two or more persons are said to have consented when they agree upon the same thing in the same manner. This is referred to as identity of minds or "*consensus-ad-idem*". Absence of identity of minds would arise when there is an error on the part of the parties regarding (a) nature of transaction or (b) person dealt with or (c) subject matter of agreement. In such cases there would be no consent. However cases of fundamental errors have to be distinguished from cases of mutual mistakes.

*Example:* Where the persons refer to a ship of a name in the contract but each of them had a different ship in mind though of same name, there is no identity of minds and hence there is no consent. That there is no contract in the absence of consent was considered in the case of *Cundy Vs Lindsay*. In this case one Blenkarn in placing order for goods with Cundy closely imitated the address and signature of another well-known firm known as Blenkiron & Co. Cundy sent the goods to Blenkarn but thinking that the order was from Blenkiron & Co. Blenkarn in turn sold the goods to Lindsay. Cundy discovered his mistake, brought a suit against Lindsay for recovery of goods. It was held by the House of Lords that Cundy was under mistake as he thought he was dealing with Blenkiron & Co, while he was in fact dealing with Blenkarn. Hence there was no contract at all. The agreement was declared as void in the



absence of identity of minds or proper consent. The suit was decreed against Lindsay.

The consent referred above must be "free consent" as well. Consent is free when it is not caused by coercion, undue influence, fraud, misrepresentation or mistake (Section 14). When the consent is caused by mistake, the agreement is void, but when caused by other factors it is voidable.

Now let us discuss each of these factors, which should not influence consent.

**(a) Coercion (Section 15):** "Coercion" is the committing, or threatening to commit any act forbidden by the Indian Penal Code 1860, or the unlawful detaining, or threatening to detain any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement.

For *example*, X says to Y 'I shall not return the documents of title relating to your wife's property, unless you agree to sell your house to me for ₹ 5000'. 'Y' says, "All right, I shall sell my house to you for ₹ 5000; do not detain my wife's documents of title", X has employed coercion; he cannot therefore enforce the contract. But Y can enforce the contract if he finds the contract to his benefit. An agreement induced by coercion is voidable and not void. That means it can be enforced by the party coerced, but not by the party using coercion.

It is immaterial whether the Indian Penal Code, 1860 is or is not in force at the place where the coercion is employed.

Where husband obtained a release deed from his wife and son under a threat of committing suicide, the transaction was set aside on the ground of coercion, suicide being forbidden by the Indian Penal Code. (*Amiraju Vs. Seshamma (1974) 41 Mad, 33*)

A person to whom money has been paid or anything delivered under coercion, must repay or return it.

**(b) Undue influence (Section 16):** A contract is said to be induced by "undue influence" where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage of the other. A person is deemed to be in a position to dominate the will of the other, when he holds authority, real or apparent over the other, or when he stands in a fiduciary relation to other.

The essential ingredients of undue influence are:

One of the parties dominates the will of the other and

- (i) he has real or apparent authority over the other;
- (ii) he is in a position to dominate the will of the other and
- (iii) the dominating party takes advantage of the relation.

Following are the *instances* where one person can be treated as in a position to dominate the will of the other.

- (i) A solicitor can dominate the will of the client.
- (ii) A doctor can dominate the will of his patient having protracted illness, and
- (iii) A trustee can dominate the will of the beneficiary.

The burden of proof (in situations like the above) that there is no undue influence in an agreement would be on the person who is in a position to dominate the will of the other. For *instance* the 'father' should prove that he had not unduly influenced his son in the case of any given agreement. The stronger party must act in good faith and see that the weaker party gets independent advice.

The following two decisions would enable us to understand the law.

- (a) Allahabad High Court set aside a gift of the whole of the property by an elderly Hindu to his spiritual advisor.
- (b) Similarly, Privy Council set aside a deed of gift executed by an old illiterate Muslim lady in favour of the manager of her estate.

**Money lending operations and undue influence:** It is often seen that on account of 'undue influence' borrowers end up paying very high rate of interest to the lenders. This is because lenders are in a position to dominate the will of the borrowers. Such high rate of interest will be treated as unconscionable where parties are not on same footing.

**Difference between Coercion and Undue Influence:** Having discussed in detail the concepts of coercion and undue influence, let us understand the difference between the two:-

- (i) **Nature of action:** Coercion involves physical force and sometimes only threat. Undue influence involves only moral pressure.
- (ii) **Involvement of criminal action:** Coercion involves committing or threatening to commit any act prohibited or forbidden by law, or detention or threatening to detain a person or property. In undue influence there is no such illegal act involved.
- (iii) **Relation ship between parties:** In coercion there need not be any relationship between parties; whereas in undue influence, there must be some kind of relationship between parties, which enables to exercise undue influence over the other.
- (iv) **Exercise by whom:** Coercion need not proceed from the promisor. It also need not be directed against the promisee. Undue influence is always exercised by one on the other, both of whom are parties to a contract.
- (v) **Enforceability:** Where there is coercion, the contract is voidable. Where there is undue influence the contract is voidable or court may set aside or enforce it in a modified form.
- (vi) **Position of benefits received:** In case of coercion, where the contract is rescinded by the aggrieved party any benefit received has to be restored back. In the case of undue influence, the court has discretion to pass orders for return of any such benefit or not to give any such directions.

(c) **Fraud(Section 17):** Fraud means and includes any of the following act committed by a party to a contract or with his connivance or by his agent with intent to deceive another party thereto or his agent or to induce him to enter into the contract.

- (i) the suggestion, as to a fact, of that which is not true by one who does not believe it be true;
- (ii) the active concealment of a fact by one, having knowledge or belief of the fact;
- (iii) a promise made without any intention of performing it;
- (iv) any other act fitted to deceive; and
- (v) any such act or omission as to law specially declared to be fraudulent

It is important to note that 'fraud' that results in a contract alone is covered by section 17 of the Act. If there is a 'fraud' but it does not result in a contract, it would not fall within the purview of the Act.

The following can be taken as *illustration* of fraud:

- ◆ A director of a company issues prospectus containing misstatement knowing fully well about such mis-statement. It was held any person who had purchased shares on the faith of such misstatement can repudiate the contract on the ground of fraud.
- ◆ B discovered an ore mine in the Estate of 'A' He conceals the mine and the information about the mine. 'A' in ignorance agrees to sell the estate to 'B' at a price that is grossly undervalued. The contract would be voidable of the option of 'A' on the ground of fraud.
- ◆ Buying goods with the intention of not paying the price is an act of fraud.
- ◆ It will be interesting to know that not only Contract Act, but also other Acts have specifically declared certain acts and omission as fraud. A seller of a property should disclose any material defect in the property. Concealing the information would be an act of fraud. Any other act committed to deceive is fraud.

**Mere silence would amount to fraud under certain circumstances.**

Although a mere silence as to facts which is likely to affect the willingness of a person to enter into a contract is no fraud, where there is a duty to speak or where his silence is equivalent to speech, then such silence amounts to fraud. This would be clearly seen from the explanation to Section 17 of the Indian Contract Act, 1872. This situation often arises in Insurance contracts.

In the case of fire insurance contract between person standing in fiduciary relationship, non-disclosure of certain information would amount to fraud as there is a duty to make special disclosure. These are also known as *uberrimae fidei* contract.

In the case of marine insurance policy contract, where a charterer is shipping goods of high value but fails to disclose such high value of the goods to the underwriter, there is fraud. Similarly the insurer is not bound by the policy issued by him where he is misinformed about insurance policy previously taken by the insured.

**(d) Misrepresentation [Section 18]:** "Misrepresentation" does not involve deception but is only an assertion of something by a person which is not true, though he believes it to be true. misrepresentation could arise because of innocence of the person making it or because he lacks sufficient or reasonable ground to make it. A contract which is hit by misrepresentation can be avoided by the person who has been misled.

For *example*, A makes the statement on an information derived, not directly from C but from M. B applies for shares on the faith of the statement which turns out to be false. The statement amounts to misrepresentation, because the information received second-hand did not warrant A to make the positive statement to B [Section 18 (1)]

**Now let us analyse the difference between fraud and misrepresentation.**

**(i) Extent of truth varies:** One of the important difference between fraud and misrepresentation is that in case of fraud the person making the representation knows it fully well that his statement is untrue & false. In case of misrepresentation, the person making the statement believes it to be true which might later turn out to be untrue. In spite of this difference, the end result is that the other party is misled.

**(ii) Right of the person concerned who suffers:** Fraud not only enables the party to avoid the contract but is also entitled to bring action. Misrepresentation merely provides a ground for avoiding the contract and not for bringing an action in court.

**(iii) Action against the person making the statement:** In order to sustain an action for deceit, there must be proof of fraud. As earlier discussed fraud can be proved only by showing that a false statement was made knowing it to be false or without believing it to be true or recklessly without any care for truth. One is for action against deceit and the other is action for recession of the contract. In the case of mis-representation the person may be free from blame because of his innocence but still the contract cannot stand.

**(iv) Defences available to persons:** In case of misrepresentation, the fact that plaintiff had means of discovering the truth by exercising ordinary diligence can be a good defence against the repudiation of the contract, whereas a defence cannot be set up in case of fraud other than fraudulent silence.

The tenuous difference between fraud and misrepresentation was beautifully brought out in the famous case of *Derry vs. Peek*. In the said case the plaintiff brought an action of deceit against the promoters of a tramway company.

According to him, the promoters in the prospectus had not mentioned that they had not obtained the permission of the board of trade which was necessary for using mechanical power [to run a train] and here this was deceit. The plea of the defendant was that it never occurred to them to say anything about the consent of the Board of trade because they had a right under the Act of parliament for using steam; they had presumed, they would also get the consent of Board of trade. The Court verified the position and concluded that there was no deceit and the plea for action for deceit was dismissed.

### 1.14 General Consequences of Coercion, Fraud, Misrepresentation Etc; (Section 19)

What is the effect and what the consequences of a contract hit by coercion, undue influence, fraud or misrepresentations, are dealt by Section 19 of the Act. It is seen that in all these cases though the agreement amounts to a contract, it is voidable. The injured party might insist on being placed in the same position in which he might have been had the vitiating circumstances not been present.

For *example* 'A' fraudulently informs 'B' that his estate is free from encumbrance, therefore 'B' buys the estate. But the estate is subject to mortgage. 'B' may avoid the contract or insist on the debt being redeemed and mortgage being released.

**But**, where it is possible to discover the truth with ordinary diligence, and though the consent might have been obtained by misrepresentation or silence, then the contract cannot be avoided.

For *instance* where 'A' misrepresents to 'B' that his sugar factory can produce 500 tons of sugar and whereas it actually produced 300 tones of sugar and if 'B' had the opportunity to examine the accounts through which he could have found out the truth and if in spite of that he had entered into a contract, he can not repudiate it.

Where a party to contract perpetrates fraud or misrepresentation, but the other party is not misled by such fraud or misrepresentation, then the contract cannot be avoided by the latter. Where for instance, the seller of specific goods deliberately conceals a fault in order that the buyer may not discover it even if he inspects the goods, but the buyer in fact does not make any inspection at all, the buyer cannot avoid the contract as he is not deceived by the seller.

Where a contract is voidable and the party entitled to avoid it decides to do so by rescinding it, he must restore any benefit which he might have received from the other party. He cannot avoid the contract and at the same time enjoy the benefit under the rescinded/avoided contract.

However where a contract is sought to be rescinded on the ground of 'undue influence' the court may set aside the contract partially or fully. Where the party seeking to rescind the contract had received only benefit, the contract will be set aside by the court upon such terms and conditions deemed fit.

*Example:* A student was induced by his teacher to sell his brand new car to the latter at less than the purchase price to secure more marks in the examination. Accordingly the car was sold. However, the father of the student persuaded him to sue his teacher. State on what ground the student can sue the teacher?

Yes, the student can sue his teacher on the ground of undue influence under the provision of Indian Contract Act, 1872. A contract brought about as a result of coercion, undue influence, fraud or misrepresentation would be voidable at the option of the person whose consent was so caused.

## 1.15 Mistake

The fifth significant element that vitiates consent is 'Mistake'. Where parties to an agreement are under a mistake as to a matter of fact which is essential to the agreement, then the agreement is void. As we all know a void agreement cannot be enforced at all.

*Example:* 'A' agrees to sell certain cargo which is supposed to be on its way in a ship from London to Bombay. But in fact, just before the bargain was struck, the ship carrying the cargo was cast away because of storm and rain and the goods were lost. Neither of the parties was aware of it. The agreement is void. [*Couturier vs Hasite 5 H.L.C.673*]

Mistake must be a matter of fact and not of law. Where 'A' and 'B' enter into contract believing wrongly that a particular debt is not barred by law of limitation, then the contract is valid because there is no mistake of fact but of law only. However a question on foreign law would become a matter of question of fact. Similarly the existence of a particular private right though depends upon rules of law, is only a matter of fact. For *instance* where a man promises to buy a property which already belongs to him without him being aware of it, then such a promise is not binding on him. However a family arrangements or a compromise of doubtful rights cannot be avoided on the ground of mistake of law.

Yet another issue to remember in mistake is that it must be of an essential fact. Whether the fact is essential or not would again depend on how a reasonable man would regard it under given circumstances. A mere wrong opinion as to the value is not an essential fact.

While deciding whether a contract is hit by mistake or not it must be remembered that 'Mistake' is not unilateral. Both the parties should be under mistake. A unilateral mistake would not render the contract invalid. For *example* where 'A' agrees to purchase from 'B' 18 carat gold thinking it to be pure gold but 'B' was not instrumental for creating such an impression then contract between 'A' and 'B' should be treated as valid.

From the foregoing it is clear that:-

- a. Mistake should be a matter of fact
- b. Mistake should not be a matter of law
- c. Mistake should be a matter of essential fact
- d. Mistake should not be unilateral but of both the parties, and
- e. Mistake renders agreement void and neither party can enforce the contract against each other

### Key Points

- ◆ When two or more persons agree upon the same thing in the same sense, they are said to have consent. Consent is said to be free when it has not been obtained by coercion, undue influence, fraud, misrepresentation or mistake.

- ◆ Coercion –An act or threat of a person with an intention of causing any person to enter into an agreement by –(i) committing / threatening to commit any act forbidden by IPC, or (ii) unlawfully detaining or threatening to detain any property of another. Such a contract is voidable.
- ◆ Undue influence –It is used by a dominant party on a weaker one to get an unfair advantage in a contract. In the following circumstances, the party stand in a dominant position-  
Where party holds real/apparent authority over the others, or party stands in a fiduciary relationship to the other, or where the party make a contract with a party in mental or bodily distress.  
A contract caused by undue influence is voidable. Even court is also empowered to set aside such contract absolutely or conditionally.
- ◆ Fraud-Intentional misrepresentation or concealment of material facts of a contract with an intention to deceive and induce the other party to enter into an agreement.  
Silence merely not amount to fraud, except-it's duty to speak, or silence is equivalent to speech, or stating half truth.
- ◆ Misrepresentation- An innocent/ unintentional false statement/ assertion of fact in the making of an agreement.  
Remedies in the above cases are same, except the right to claim damages in case of fraud.
- ◆ Mistake- An erroneous belief about something. It may be either of fact or of law. Mistake renders the contract void. Unilateral mistake made by one of the parties. It is a valid contract, unless it is caused by misrepresentation or fraud. Even unilateral mistakes as to fact renders the contract void.

### 1.16 Capacity to Contract

The next issue for consideration is, who is competent to contract? Every person who (a) has attained the age of majority (b) is of sound mind and (c) is not otherwise disqualified from contracting, is competent to contract. Now let us discuss each one of these requirements.

(a) **Age of majority:** In terms of the Indian Majority Act, 1875, every domiciled Indian attains majority on the completion of 18 years of age. However where a guardian is appointed by a court to protect the property of a minor and the court takes charge of the property before the person attains 18 years, then he or she would attain majority on completion of 21 years.

Now let us analyze the position with regard to the minor's agreement -

(i) **An agreement entered into by a minor is altogether void:** An agreement entered into by a minor is void against the minor and the question of its enforceability does not arise. The Privy Council in *Mohiri Bibee vs. Dharmodos Ghose* [1903] LR 30, Cal 539, decided that an

agreement where minor is a party is altogether void. In this case a minor executed a mortgage in favour of the husband of Mohiri Bibee. The question for consideration is whether the mortgage is valid. Interpreting Sections 10 & 11 of the Indian Contract Act, 1872 Privy Council held that unless all the parties to an agreement were competent to contract, the agreement would be void. The main reason for such a view is that a minor is incapable of performing his part of the contract imposing a legal obligation.

(ii) **Minor can be a beneficiary:** Though a minor is not competent to contract, nothing in the Contract Act prevents him from making the other party bound to the minor. Thus, a promissory note duly executed in favour of a minor is not void and can be sued upon by him, because he though incompetent to contract, may yet accept a benefit.

A minor cannot become partner in a partnership firm. However, he may with the consent of all the partners, be admitted to the benefits of partnership (Section 30 of the Indian Partnership Act, 1932).

(iii) **Minor can always plead minority:** Any money advanced to a minor cannot be recovered as he can plead minority and that the contract is void. Even if there had been false representation at the time of borrowing that he was a major, the amount lent to him cannot be recovered.

This position was upheld by Privy Council in *Mohiri Bibee's* case where money was lent to a minor with full knowledge of the borrower's infancy and even request for payment of compensation under sections 38 & 41 of the Specific Relief Act, 1963 was refused. Privy Council concurred with the views of Calcutta High Court that no discretion could be used even under that Act to grant any kind of relief to the lender of money.

When the mortgage documents had to be cancelled at the instance of minor who mortgaged the property fraudulently, Courts have ordered compensation under Specific Relief Act, 1963 to the other party to the instrument [*Dattaram vs. Vinayak* (1903) 28 Bom. 181., *Manmatha Kumar vs. Exchange Loan Co.* 41 C.W.e.N 115]

If a minor had obtained payment fraudulently by concealing his age, he may be compelled to restore the payment but he cannot be compelled for an identical sum as it would amount to enforcing void contract.

(iv) **Ratification of agreement not permitted:** A minor on his attaining majority cannot validate any agreement which was entered into when he was minor, as the agreement was void. Similarly a minor cannot sign fresh promissory notes on his attaining majority in lieu of promissory notes executed for a loan transaction when he was minor, or a fresh agreement without consideration.

(v) **Liability for necessities:** A person who supplied necessities of life to a minor or his family, is entitled to be reimbursed from the properties of a minor, not on the basis of any contract but on the basis of an obligation resembling a contract. Necessaries of life not only include food and clothing but also education and instruction. They also include 'goods' and 'services'.



(vi) **Contract by guardian are valid:** Though an agreement with minor is void, valid contract can be entered into with the guardian on behalf of the minor. The guardian must be competent to make the contract and the contract should be for the benefit of the minor. For *instance* a guardian can make an enforceable marriage contract on behalf of the minor. Similarly father of bride can enter the contract with the father of bridegroom for payment of certain allowance to the bride.

But not all contracts by guardian are valid. A guardian cannot bind a minor in a contract to purchase immovable properties [*Mir Sarwarjan vs. Fakharuddin (1912) 39. Cal. 232*]. However, a court appointed guardian can bind a minor in respect of certain sale of property ordered by the court.

**Key Points**

- ◆ Capacity to contract -Legal capacity of parties to enter into a contract. A person is competent to contract, where he is – (i) Major (ii) of Sound mind (iii) not disqualified by any other law of the land.
- ◆ Nature of minor's agreement- Minor's agreement is absolutely void from very beginning, so it has no enforceability. [*Mohiri Bibee v. Dharmodas Ghose*].
- ◆ Minor can be a beneficiary.
- ◆ Minor cannot ratify his agreement even after attaining the age of majority.
- ◆ Minor can always plead his minority, as no rule of estoppel is applicable to minor.
- ◆ Minor, is not personally liable for the necessities supplied to him/ or his legal dependants

(b) **Sound mind:** The next important requirement by way of capacity to contract is "sound mind". A person will be considered to be of sound mind if he at the time of entering into a contract is capable of understanding it and forming a rational judgment as to its effect upon his interest. A person who is of unsound mind but occasionally of sound mind can enter into a contract when he is in sound mind though for temporary periods. For *example* a person who is in lunatic asylum during intervals of sound mind can enter into contracts. Similarly, a person who is generally of sound mind, but occasionally of unsound mind cannot enter into a contract when he is of unsound mind.

From the above it is clear that the period of lucidity would be crucial as much as the periods of lunacy. But the burden of proof of 'unsound mind' is on the person who challenges the validity of the contract.

A lunatic whose estate is managed by a committee or manager is not capable of entering into a contract even during the periods of lucidity in view of special provisions of Lunacy Act.

The basic test for lunacy or lucidity is to see whether the person is able to understand the implications of a contract which he enters into on his interest. Idiots, lunatics and drunken persons are examples of persons of unsound mind.

**Necessaries of life supplied to a person of unsound mind:** In term of section 68 of the Indian Contract Act, 1872 if a person incapable of entering into a contract is supplied by another person with necessaries of life, the person who has furnished such supplies is entitled to be reimbursed from the property of such a person.

(c) **Contract by disqualified persons:** Apart from minors and persons of unsound mind, these are the others who are not capable of entering into contract either wholly or partially. Contract by such persons are void.

An alien enemy, during war cannot enter into a contract with an Indian subject, unless he is permitted by Central Government to do so he cannot sue in Indian Courts. This disability to an alien enemy arises on account of public policy. Statutory corporations or Municipal bodies cannot enter into contracts on matters which are beyond their statutory powers or ultra vires the memorandum or articles through which they are created.

An Advocate in India can enter into contracts with his clients for recovery of fees or payment of fees in certain manner unlike his counterpart in U.K where barristers are prohibited to enter into contracts for recovery of fees from their clients [*Nichal chand vs. Dilawar Khan* 55. All 790]

Before entering into contract with the government, certain procedure and formalities are required to be complied with. On default of it, such contract will be void. [*Bikhraj vs. Union of India* (1962) 2 S.C.R.880, *Karamshi vs. State of Bombay* AIR (1964) S.C.1714]

Sovereign states, Ambassadors and Diplomatic Consuls enjoy certain privileges with the result that they cannot be proceeded against in Indian Courts. However, they can, at their will enter into contracts which may be enforceable in India.

#### Key Points

- ◆ Person is said to be of sound mind for the purpose of making a contract, where he is- (a) capable of understanding the nature of the contract, and (b) capable of making a rational judgement as to effect upon its interests.
- ◆ Insanity is required only at the time of making a contract.
- ◆ A person usually of unsound mind, but occasionally of sound mind- can make contract when he is of sound mind.
- ◆ A person usually of sound mind, but occasionally of unsound mind- cannot make contract when he is of unsound mind.
- ◆ The agreements made by a person of unsound mind are absolutely void.
- ◆ Certain persons who are disqualified from contracting by other laws are- Alien enemy, Foreign diplomats & Consuls, Artificial persons, Insolvents, and Convicts.

### 1.17 Lawful Object and Consideration

Now let us discuss two other important ingredients of a valid contract namely lawful object and lawful consideration. Speaking generally all persons enjoy freedom for entering into contracts

of their choice. But this contractual freedom or their right to enter into agreements is not absolute. There is a limitation on such contractual freedom as they are bound by certain general provisions of law. The above observation can be illustrated with the following *example*: suppose 'A' agrees to pay ₹ 100/- to B on 'B' stealing 'C's purse, then no Court can compel 'A' to pay 'B' even if he manages to steal 'C's purse because it would amount to encouraging these things.

While on the subject of 'object' and 'consideration' it must be said that in practice it is difficult to distinguish between 'object' and 'consideration' especially when consideration consists of a promise to do or, not to do something. Sometimes both 'object' and 'consideration' are seen for evaluation. For *example*, where 'A' agrees to sell goods to 'B' who is insolvent and B assigns the benefit of the contract for ₹ 100/- with a view to defrauding creditors, the consideration for the assignment viz ₹ 100/- is lawful but the object namely defrauding creditors is unlawful as it is to defeat the provision of insolvency law.

Although 'object' and 'consideration' are sometimes intertwined we have to, where ever it is possible, separate them and identify whether they are lawful.

### 1.18 Unlawful Object

In terms of section 23 of the Act 'consideration' or 'object' is unlawful if it is forbidden by law; or it would if permitted, defeat the provisions of any law or is fraudulent or involves injury to the person or property of another or is immoral or opposed to public policy. Every agreement where the object or consideration is unlawful is void. Thus section 23 has set out the limits to contractual freedom. Following are *examples* of agreement which are void because the object is unlawful.

- (i) Where A, B & C enter into an agreement to share equally among themselves certain gains acquired by fraud or loss acquired by fraud. The agreement is void because the object being commission of fraud, is unlawful.
- (ii) A promises to return the stolen property of 'B' if 'B' would withdraw the criminal case filed against him, the agreement is void as its object namely withdrawing the case would mean stifling prosecution.

### 1.19 Unlawful Consideration

Now let us consider circumstances which would make consideration and the object as well unlawful. There are seven such circumstances namely -

- (i) **Agreement forbidden by law:** Acts forbidden by law means acts that are punishable under any Statute or Rules or Regulations made under any Statute.

For *instance* a plantation company that is commenced, for growing, felling and selling timber cannot enter into any agreement to grow and fell sandalwood trees as felling of sandalwood is prohibited by law viz the Forest Act.

*Example:* A license to cut grass is given to 'X' by Forest Department under the Forest Act. The license provides for imposition of penalty in the events of 'X' choosing to assign his right. However, if 'X' assigns his right, the agreement would still be valid since there is no prohibition for such assignment as the consideration stipulating penalty is only to regulate the matter as a matter of administrative measure.

**(ii) Consideration defeats the provision of law:** Where an agreement is entered into with the object of defeating any provision of law then it is prohibited. "Law" here should mean any Statute, Law, regulation etc, in force. This can be *illustrated* by the following-

- (a) Where a debtor agrees not to plead limitation vis-à-vis his creditor, it is an agreement to defeat the Limitation Act.
- (b) An agreement between owner of land who has to pay land revenue in arrears and a stranger that the stranger would purchase his estate for revenue's sake and reconveys it to the former on receipt of purchase money is void, as it would defeat the law relating to revenue, which apparently prohibits defaulting owners from purchasing back the same estate already sold due to his default.
- (c) An agreement by a Hindu to give his son in adoption in consideration of annual allowance to natural parents would be in violation of Hindu Law and hence is unlawful.
- (d) Any agreement by a Muslim with the wife before their marriage that the wife shall be at liberty to live with her parents after marriage is void as it would defeat the provisions of Muslim Law.

**(iii) Consideration that would defeat any rule for the time being in force:** This is a situation not very different from point (ii) discussed above. The issue covered by this point can be explained by following two *examples*:

- (a) A 'will' must be proved in order to be probated by a court. A mere consent of parties by way of agreement to except this requirement of proof of genuineness or proper execution of will is not lawful and therefore cannot be enforced under C.P.C.
- (b) A receiver is a court officer. Therefore his remuneration has to be fixed by the court. Parties to certain litigations cannot add or deviate of the power of the receiver. Similarly they cannot fix salary of a receiver without the leave of the court however unconditional it may be. Such an act would be in contravention of law.

**(iv) Where consideration is a fraud:** Following are *illustrations* to prove where the object or consideration of an agreement is unlawful on the ground of fraud -

- (a) 'A' is an agent for Zamindar, the principal. He agrees for money to lease of land for 'B' from his principal, the Zamindar. The agreement between 'A' and 'B' is void as the consideration is fraudulent
- (b) 'A' & 'B' are partners in a firm. They agree to defraud a Government department by submitting a tender in the individual name and not in the firm name. This agreement is void as it is a fraud on the Government department.

(v) **Where object or consideration is unlawful because it involves or causing injury to a person or loss of property:** The term 'injury' means criminal or wrongful harm. Following are the *illustrations* where the object or consideration is unlawful as it involves injury either to person or property.

- (a) 'A' agrees to buy a property from 'B' although A knows 'B' had agreed previously to sell the property to 'C'. The intention of 'A' here is to cause injury to the property of 'C'
- (b) 'A' agrees to print a book of 'B' which has clearly been published by "W" This agreement is void as it is not only in violation of Copyright Act but also with the intent to cause injury to the property of another.
- (c) 'A' borrowed money from 'B'. He is unable to pay either the principal or interest. Therefore he agrees to render manual labour for certain period failing which he agrees to pay exorbitant interest. This agreement is void as rendering labour as consideration amounts to agreeing to be a slave. Slavery is opposed to public policy as well. In other words consideration involves 'injury' to 'A'. Hence the agreement is void.

(vi) **Where consideration is immoral:** Following are *illustration* where the agreement is void because the object or consideration is unlawful being immoral.

- (a) Where 'A' agrees to let his house to a prostitute on rent, where with A's knowledge she carries on her vocation. 'A' cannot collect the rent as the agreement is void, the object being void.
- (b) Where 'P' had advanced money to 'D' a married woman to enable her to obtain a divorce from her husband. He also promised to marry her after divorce. It was held that 'P' was not entitled to recover the amount from 'D' as the agreement was against good morals.

(vii) **Where consideration is opposed to public policy:** Agreement, either because of their object or consideration being opposed to public policy are void and not enforceable. Therefore the meaning of the expression 'public policy' is very important. It can be interpreted in a narrow sense or in a broad sense. If it is understood in a narrow sense, it would cut into rights of people to enter into even genuine agreements. 'Public policy' as a concept is evolved basically to develop an orderly society and for good of the community. But framing public policy itself is a difficult exercise since a too restrictive approach would stifle the rights of people and a too liberal approach would open the gate for many illegal transactions. Therefore policy on 'public policy' has to be developed with circumspection. Public policy has been described as "*an unruly horse, which if not properly bridled, may carry its rider he knows not where*". Time immemorial following activities/ agreements have been identified as "opposed to public policy".

(a) **Trading with enemy:** Any trading or business activity with a person who owes allegiance to a Government of a country with whom India is at war without any license from Government of India is void. This is because such a trade would be against the interest of Government of India and people of India.

Any agreement made during peace time would be suspended automatically and cannot be

carried on further until hostilities come to an end.

(b) **Stifling prosecution:** Any agreement to stifle or prevent illegally any prosecution is void as it would amount to perversion or abuse of justice. The principle is that one should not make a trade of felony. It must be understood however that under the Code of Criminal Procedure, 1973 many offences are compoundable. Therefore any agreement towards compounding of an offence to avoid prosecution is not void but is very much enforceable. Thus, where 'A' agrees to sell certain land to 'B' in consideration of 'B' abstaining from taking any criminal proceeding against 'A' with respect to an offence which is compoundable, the agreement is not opposed to public policy.

(c) **Maintenance and Champerty:** Maintenance is promotion of litigation in which the litigant has no interest. Champerty is bargain whereby one party agrees to assist the other in recovering property with a view to sharing the profit of litigation. These agreements for maintenance and champerty are void in England but not in India. Hence these are not opposed to public policy. But where such advances are made by way of gambling in litigation, the agreement to share the subject of litigation is certainly opposed to public policy and therefore is void.

(d) **Interference with course of law and justice:** Any agreement with the object of inducing a judicial officer or administrative officer of the state to act corruptly or not impartially is void. Similarly an agreement to use influence in a litigation in a underhand manner is void. For instance through an agreement 'A' agrees to reward 'B' if he abstains from being a witness in a suit against 'A' is void. But an agreement to pay for to a holy man for prayers for success of a suit is valid.

(e) **Marriage brokerage contract:** An agreement to negotiate a marriage for reward is void. Such marriage brokerage contracts are opposed to public policy.

(f) **Interest against obligation:** The following are *examples* of agreement that are void as they tend to create an interest against obligation. The object of such agreements is opposed to public policy.

- (1) An agreement by an agent to receive without his principal's consent compensation from another for the performance of his agency is invalid.
- (2) A promise by a trustee to do something in violation of his duty is unlawful
- (3) A, who is the manager of a firm, agrees to pass a contract to X if X pay to A ₹ 2000 privately; the agreement is void.

(g) **Sale of public offices:** While appointing a person to certain important and high public office, merit alone should be the criteria. Any attempt to influence or any agreement to influence anyone in this regard should be seen as an act 'opposed to public policy'. 'Public policy' also demands that there should be no money consideration and if it is there, it could be opposed to public policy. This is for the reason presence of money consideration would convert the situation as sale of public office.

Following are *illustrations* in this regard.

- (1) An agreement to pay money to public servant in order to induce him to retire from his office so that another person may secure the appointment is void.
- (2) An agreement to procure a public recognition like Padma Vibhushan for reward is void.
- (3) The sale of the office of a mutawali of wakf is opposed to public policy, because the office of mutawali is connected with matters of public interest.
- (h) **Agreement for the creation of monopolies:** Agreements having for their object the establishment of monopolies are opposed to public policy and therefore void. It is also hit by the MRTP Act.
- (i) **Agreement in restraint of marriage (Section 26):** Every agreement in restraint of marriage of any person other than a minor, is void. So if a person, being a major, agrees for good consideration not to marry, the promise is not binding.
- (j) **Agreement in restraint of trade (Section 27):** Any agreement through which a person is restrained from exercising a lawful profession, trade or business of any kind is to that extent void. The object of this law is to protect trade. The restraint, even if it is partial, will make the agreement void. *Example:* X, a shop keeper, in a particular locality agrees to pay 'Y' his rival in business certain compensation, if 'Y' close his business in that locality the agreement is void.

The principle of law however has a number of *exceptions* which are discussed hereunder.

- (i) where a person sells his business along with the goodwill to another person, agrees not to carry on same line of business in certain reasonable local limits, such an agreement is valid.
- (ii) In terms of Section 36 of the Indian Partnership Act, 1932 an agreement through which an outgoing partner will not carry on the business of the firm for a reasonable time will be valid, though it is in restraint of trade.
- (iii) Again in terms of Section 54 of the Partnership Act, 1932 partners among themselves may agree that upon dissolution of the firm some of them may not carry on the business of the firm. Such an agreement is valid.
- (iv) Section 55 of the Indian Partnership Act, 1932 provides that where a full firm is sold by partners along with goodwill to a buyer, there can be an agreement that they would not carry on the business of the dissolved firm for certain period and within certain local limits and such an agreement will be valid.
- (v) An agreement of service through which an employee commits not to compete with his employer is not in restraint of trade. *Example:* 'B' is a Doctor and he employs 'A' a junior Doctor as his assistant. 'A' agrees not to practice as Doctor during the period of his employment with 'B' as a Doctor independently. Such an agreement will be valid.

- (vi) An agreement between manufacturer and a wholesale merchant that the entire production during a period will be sold by the manufacturer to the wholesale merchant is not in restraint of trade.
- (vii) An agreement among sellers not to sell a particular product below a particular price is not an agreement in restraint of trade.
- (k) **Agreement in restraint of legal proceedings (Section 28):** An agreement in restraint of legal proceedings resulting in restriction of one's right to enforce legal rights is void. Similarly any agreement which abridges the usual period for commencing the legal proceedings is also void. Further these agreement are also void in view of section 23 of the Indian Contract Act, 1872 as the object of the agreements are to defeat the provision of law.

Nevertheless, a clause in an fire insurance policy stipulating that if the claim is made and rejected and if no suit is instituted within three months after such a rejection, all the benefits under the policy will be forfeited, is valid. However, there are certain *exceptions* to the above rule:

- (i) A contract by which the parties agree that any dispute between them in respect of any subject shall be referred to arbitration and that only the amount awarded in such arbitration shall be recoverable is a valid contract. For *instance*, in agreement between the holder of a fire insurance policy and the insurance company that no suit shall be instituted until the question of the amount of damage sustained by the assured has first been ascertained by a reference to an arbitrator is a perfectly valid agreement.
- (ii) Similarly, a contract by which the parties agree to refer to arbitration any question between them which has already arisen or which may arise in future, is valid; but such a contract must be in writing.

#### Key Points

- ◆ An agreement with unlawful object or consideration is void.
- ◆ Where both the consideration and object of an agreement is partially unlawful and it can not be severed from the agreement- Whole agreement is void.
- ◆ If unlawful part can be severed from the other lawful part of an agreement - Lawful part is valid.
- ◆ Any agreement which is against the interest of the public or harmful to the society-Is an agreement against public policy.

### 1.20 Agreement Expressly Declared as Void

We have already seen that certain agreements are void ab initio under the Contract Act, like agreements by incompetent persons [Section 11], agreement with unlawful object or consideration [Section 23], agreement made under mutual mistake of fact [Section 20], agreement without consideration [Section 25], agreement in restraint of marriage, trade or legal proceedings etc., as they are opposed to public policy.



In addition to the above, there are also other agreements which are expressly declared as void.

**(a) Where consideration is unlawful in part:** By virtue of Section 24 of the Indian Contract Act, "If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object is unlawful, the agreement is void".

This Section is obviously a corollary to Section 23 of the Act. Where the consideration is unlawful, the entire agreement is void as the agreement has to be looked as a whole. The general principle of law is where the legal part of an agreement can be separated from the illegal part, then the legal part if it can be given effect by rejecting the bad part and retaining the good part, then the good part is given effect. But where no such separation is possible, the contract is altogether void.

*Example:* 'A' has business interest in Indigo, as a manufacturer. He also has interest in illegal traffic of other goods. Where 'A' employs 'B' for a salary of ₹ 2000/- to act as superintendent of A's entire business, the agreement is void as the object of A's promise unlawful in part.

**(b) Agreement the meaning of which is uncertain (Section 29):** Where the meaning of the terms of an agreement is uncertain or if it is not capable of being understood with certainty, then the agreement is void. But where the meaning is capable of being made certain, then the agreement is valid. For *example* where 'A' enters into an agreement to supply 100 tones of oil, the agreement is not valid as the meaning of it is uncertain since what type of oil that is promised to be supplied is not clear. But on the other hand if 'A' is a dealer of coconut oil only, then the meaning of the agreement would crystallize very easily and then the agreement would be valid.

**(c) Wagering agreement:** Let us discuss wagering contract. We shall also distinguish wagering agreements from speculative transactions and mere 'gambling'.

Wagering agreement is one which involves payment of a sum of money upon the determination of an uncertain event. The essence of wagering agreement is where there are two parties, one wins, the other loses upon an uncertain event taking place in which neither of them has legitimate interest.

For *example* 'A' agrees to pay ₹ 500/- to 'B' if it rains and similarly 'B' agrees to pay 'A' if it does not. This is a classic case of a wagering agreement. But where one of the parties has control over the event, the agreement is valid. An agreement by way of a wager is void. A good definition of wagering agreement would be the one given by Anson: "A promise to give money or money's worth upon determination or ascertainment of an uncertain event".

Now let us see the position with regard to transaction of "purchase of lottery ticket" and "horse racing". Section 30 of the Act provides that an agreement [to buy lottery tickets] is one by way of wager and is void. However any subscription or contribution or agreement towards such subscription or contribution towards any plate or prize or sum of money, of the value of ₹ 500 or more to be awarded to a winner of a horse race is not unlawful.

**Speculative transactions:** While as clearly seen, wagering contracts are void, speculative

transactions are valid. It is often difficult to distinguish between the two. There are two bare elements of a speculative transaction. They are (a) mutual intention of parties to acquire or deliver goods or commodities and (b) undertaking of risk arising from movement of prices. In wagering contract, only the element of risk is seen.

Now let us take an *example*:

'A' enters into a agreement with 'B' to buy 100 bales of jute at ₹ 150/- per bale for forward delivery after six months. This is a proposed transaction of purchase @ ₹ 150/- per bale. What if the price at the time of delivery goes up to ₹ 200/- 'A' has the following two options:

- (i) to take delivery of 100 bales at the contracted rate of ₹ 150/- and sell it to some other buyer and make a profit of ₹ 50/- per bale or
- (ii) to simply collect the difference of ₹ 50/- per bale from 'B'

Similarly what if the price at the time of delivery goes down to ₹ 125/- per bale. 'A' has the following two options:

- (i) to take delivery of 100 bales at the contracted rate of ₹ 150/- [and perhaps sell it to some buyer and incur a loss of ₹ 25 per bale] or
- (ii) to pay the difference of ₹ 25/- per bale to 'B' & close the contract.

In the above *example* if the original intention of the parties was only to settle the difference in price, than it would be a wagering contract which would be void. Thus by now it would be clear that wagering postulates only incurring of risk. It is void because it is opposed to public policy.

While gambling and wagering are prohibited by law, speculation is not.

Now let us consider other peculiar situations to see whether they are wagering contracts or speculative contracts or valid contracts.

**Insurance policy:** An insurance policy is a valid contract. But if an insurance policy is taken by a person who has no insurable interest, then it is void. For *instance* a person who has no insurable interest in a ship, takes a policy against it being sunk, then the contract is void.

**Promissory notes on a wagering contract:** While a wagering contract is void ab initio, it is but automatic that a promissory note given out of a wagering contract is not enforceable by way of a suit. A promissory note of this character is one without consideration and hence is null and void.

**Suit to recover deposit:** A winner of bet cannot recover the amount which he has won even if the amount is kept by way of deposit by the loser with the stakeholder. Such earmarking or identification of funds does not enhance the validity of the contract which is void. In the above example the loser can recover the amount from stakeholders as long as the amount has not been made over by the stakeholder to the winner.

**Wager and collateral transactions:** The validity of a collateral transaction cannot be challenged because the main contract is a wager and void. For *instance* in a wagering

contract, the broker is entitled to collect his brokerage. Similarly the principal can recover the prize money from his agent received by him on account of a wagering transactions.

The acid test of validity of a collateral transaction is whether the main transaction is illegal or legal but void. If the main transaction is illegal, the collateral transaction cannot be valid. For *example* security given for regular payment of the rent of a house let out for the purpose of gambling cannot be recovered; the recovery of security being tainted with the illegality of original transaction cannot be enforced.

A promise made by the loser of a wager to pay the amount lost in consideration of the winners forbearance to sue him as defaulter can be enforced as a fresh contract, separate and distinct from original wagering contract though collateral to it.

#### Key Points

- ◆ An agreement not enforceable by law is void. In the public interest, some of the agreements have been expressly declared to be void under the Act.
- ◆ Any agreement in restraint of marriage of a person, other than minor is void.
- ◆ Every agreement by which any person is restrained from exercising a lawful profession, trade or business of any kind is void.
- ◆ Wagering agreements have been declared to be void. However, an agreement to subscribe towards and plate, prize or a sum of money of ₹ 500 /more to be awarded to the winner of any horse race, is not unlawful. Contract of insurance is not a wager, it falls under the category of contingent contract.

## UNIT – 4 : PERFORMANCE OF CONTRACT

### Learning objectives

After studying this unit, you would be able to -

- ◆ Understand how obligations under a contract must be carried out by the parties.
- ◆ Be familiar with the various modes of performance.
- ◆ Be clear about the consequence of refusal of performance or refusal to accept performance, by either of the parties.
- ◆ Understand rights of joint promisees, liabilities of joint promisors, and rules regarding appropriation of payments.

A contract being an agreement enforceable by law, creates a legal obligation, which subsists until discharged. Performance of the promise or promises remaining to be performed is the principal and most usual mode of discharge. This unit explains, who must perform his obligation; what should be the mode of performance; and what shall be the consequences of non performance.

**Basic tenet of performance:** In a contract where there are two parties, each one has to perform his part and demands the other to perform. This obligation is the primary tenet. The parties would be treated as having been absolved only under the provisions of any law or by the conduct of the other party. Until such time, the performance is neither excused nor dispensed with. Not only the promisor has a primary duty to perform, even the representative in the event of death of a promisor, is bound by the promise to perform, unless a contrary intention appears from the contract [Section 37].

### 1.21 By Whom a Contract may be Performed

The promise under a contract can be performed by any one of the following:

- (i) **Promisor himself:** Invariably the promise has to be performed by the promisor where the contracts are entered into for performance of personal skills, or diligence or personal confidence, it becomes absolutely necessary that the promisor performs it himself.
- (ii) **Agent:** Where personal consideration is not the foundation of a contract, the promisor or his representative can employ a competent person to perform it.
- (iii) **Representatives:** Generally upon the death of promisor, the legal representatives of the deceased are bound by the promise unless it is a promise for performance involving personal skill or ability of the promisor. However the liability of the legal representative is limited to the value of property inherited by him from the promisor.
- (iv) **Third Person:** The question here is whether a total stranger to a contract who is identified as a third person can perform a promise. Where a promisee accepts performance from a third party he cannot afterwards enforce it against the promisor.

Such a performance, where accepted by the promisor has the effect of discharging the promisor though he has neither authorized nor ratified the act of the third party.

- (v) **Joint promisors:** Where two or more persons jointly promise, the promise must be performed jointly unless a contrary intention appears from the contract.

Where one of the joint promisors dies, the legal representative of the deceased along with the other joint promisor(s) is bound to perform the contract.

Where all the joint promisors die, the legal representatives of all of them are bound to perform the promise.

The law set out above can be illustrated with the following *examples*:

1. A promises B to pay ₹ 1000/- on delivery of certain goods. A may perform this promise either himself or causing someone else to pay the money to B. If A dies before the time appointed for payment, his representative must pay the money or employ some other person to pay the money. If B dies before the time appointed for the delivery of goods, B's representative shall be bound to deliver the goods to A and A is bound to pay ₹ 1000/- to B's representative.
2. A promises to paint a picture for B for a certain price. A is bound to perform the promise himself. He cannot employ some other painter to paint the picture on his behalf. If A dies before painting the picture, the contract cannot be enforced either by A's representative or by B.
3. A delivered certain goods to B who promise to pay ₹ 5000/-. Later on B expresses his inability to clear the dues. C, who is known to B, pays ₹ 2000/- to A on behalf of B. Before making this payment C did tell B nothing about it. Now A can sue B only for the balance and not for the whole amount.

## 1.22 Distinction between Succession and Assignment

This discussion arises in the context of the observation that the obligations of a promisor would bind the legal representative also (only) to the extent of value of property inherited by them. This became the law that legal representatives are successors.

**Succession:** When the benefits of a contract are succeeded by a process of law, both the burden and the benefit would some times devolve on the legal heir. For *example* 'B' is the son of 'A'. Upon A's death 'B' will inherit all the assets and liabilities of 'A' [These assets and liabilities are also referred to as debts and estates]

Thus 'B' will be liable to all the debts of 'A', but if the liabilities inherited are more than the value of the estate [assets] inherited it will be possible to pay only to the extent of assets inherited.

**Assignment:** Unlike succession, the assignor can assign only the assets to the assignee and not the liabilities. Because when a liability is assigned, a third party gets involved in it. The debtor cannot through assignment relieve himself of his liability to creditor.

However there cannot be any assignment of benefit of a contract coupled with a liability or when a personal consideration has entered into making of the contract then the contract cannot be assigned. In *Zaffer Mehar Ali vs Budge Budge Jute Mills Company Ltd.* 33 Cal., 'A' agreed to sell certain gunny bags to 'B' which were to be delivered in monthly installments for a period of 6 months and the contract contained certain options for the buyer as regards quality and packing. It was held that the clause relating to the buyer's option did not preclude the assignment of the contract.

### 1.23 Effects of Refusal to Accept Offer of Performance

In any promise, the promisor should act first by offering performance also known as 'tender'. In terms of section 38 of the Act, where the promisee has not accepted the offer or tender of performance by the promisor then the promisor is not responsible for non performance. In this case the promisor does not also lose his rights under a contract.

The promisor should however ensure that his tender or offer to perform his part should satisfy following conditions.

- (i) the offer is unconditioned.
- (ii) the offer is made at a proper time and place under such circumstances that the person to whom it is made may have a reasonable opportunity of ascertaining that the person by whom it is made is able and willing to do what he is bound to do, then and there.
- (iii) if the offer is an offer to deliver any thing to the promisee, then the promisee must have a reasonable opportunity of seeing that the thing offered is the thing that the promisor is bound by his promise to deliver.

The above legal principles were settled in the famous English case *Start up vs. Macdonald* 1843 6 Man. & G. 593, 610 thus "The law considers a party who has entered into a contract to deliver goods or pay money to another as having substantially performed it, if he has tendered the goods or money to the party to whom the delivery or payment was to be made, provided only that the tender has been made under such circumstances that the party to whom, it has been made, has had a reasonable opportunity of examining the goods or the money tendered in order to ascertain that the thing tendered is really what that it is purported to be".

An offer to any one of the several joint promisees has the same legal consequence as an offer to all of them.

### 1.24 Effect of a Refusal of a Party to Perform Promise

Where a party to a contract has refused to perform the promise he has made or had disabled himself from performing his promise in its entirety, the promisee may put an end to the contract, unless his acquiescence in the continuance of the contract has been conveyed either by words or by deeds [conduct] [Section 39]. Thus from the above it could be seen that the following two rights accrue to the aggrieved party- (i) to terminate the contract and (ii) to indicate by words or conduct that he is interested in its continuance.

In case the promisee decides to continue the contract, he would not be entitled to put an end to the contract on this ground immediately. In either case, the promisee would be able to claim damages that he suffers as a result of the breach for it is not incumbent on the promisee to decide immediately in case of an anticipated breach that the contract may be ended. He may, however, choose to do so. In that event, the loss (if any) suffered by him will have to be made good by the promisor. On the other hand, if he indicates that he is interested in the performance of the contract, then he would be entitled to claim damages which accrue on the date the contract is due to be performed. It would, therefore, be clear that the rights that we have just stated above accrue to a promisee when the promisor decides not to perform the promise.

It has been held by the Privy Council in *Muralidhar Chatterjee vs. International Film Company* 47 Cal.W.N.407 that when a promisee puts an end to a contract being rightly entitled to do so, it shall be deemed as if he has rescinded a voidable contract. In view of Section 64 of the Act, the promisee, in the events of his putting an end to the contract, is bound to return all the benefits received under the contract and in turn is entitled for compensation for all damages sustained by him for breach of contract by the promisor.

### 1.25 Liability of Joint Promisor & Promisee

The legal liability of a joint promisor, joint promisee and other connected issues are set out in Sections 42, 43 & 44 of the Indian Contract Act, 1872.

In terms of Section 42 of the Act "when two or more persons have made a joint promise then unless a contrary intention appears from the contract, all such person, during their joint lives, and after the death of any one of them, his representative jointly with the survivor or survivors and after the death of last survivor, representatives of all jointly must fulfill the promise".

The above law can be illustrated with the following *example*. Where 'A', 'B' and 'C' jointly borrow a sum of money from 'X' all of them are jointly liable to repay the amount. Where in the above *example*, 'A' dies, his legal representative, 'L' would be liable to repay the loan along with 'B' and 'C', the remaining joint borrowers.

Now let us consider the position whether the promisee can enforce his right against any one of the joint promisors and if so what are the rights and duties of the other promisors to make contributions.

In terms of Section 43 of the Act,

- (i) when two or more persons make joint promise, the promisee can compel any one of the joint promisors to perform the whole of promise.
- (ii) in the above situation, the performing promisor can enforce contribution from other joint promisors, in the absence of express agreement to the contrary.

*Example:* Where A, B and C have jointly signed a promissory note for ₹ 3000/- , and where 'A' is compelled to pay the entire amount of ₹ 3000/- , he is entitled recover by way of contribution of ₹ 1000/- each from the other two joint promisors namely B and C unless

agreed to otherwise mutually.

In the above situation again, if one of the joint promisors namely 'B' is unable to contribute ₹ 1000/-, 'A' is entitled to recover ₹ 1500/- from 'C' who is the remaining joint promisor instead of ₹ 1000.

From the above, it is clear that the liability of joint promisors is joint and several and in the absence of any special contract to the contrary, the amount due can be recovered from any one of the joint promisors.

For *example* X, Y and Z jointly borrow from P, ₹ 3000/-, Because the liability of the borrower is joint and severed, 'P' can recover the amount either from X or from Y or from Z or from all of them jointly. A joint promisor cannot claim that he be sued along with all other joint promisors only. If, however the promisee sues one of the promisors and obtains a decree against him, he is precluded from bringing a fresh suit against the remaining borrowers.

In the matter of release of one of the joint promisors, by another joint promisor, it must be understood that such a release does not discharge other joint promisors nor does the released joint promisor would stand released to other joint promisor or promisors. [Section 44 of the Act].

## 1.26 Rights of Joint Promisees

The rights of two or more promisees who are known as joint promisees is discussed in Section 45 of the Act. In terms of the said section "When a person has made a promise to two or more persons jointly, then unless a contrary intention appears from the contract, the right to claim performance rests, as between him and them, with them during their joint lives, and after the death of any of them with the representatives of such deceased person jointly with the survivor or survivors, and after the death of the last survivor, with the representatives of all jointly".

For *example*, A, in consideration of ₹ 5,000 lent to him by B and C, promises B and C jointly to repay the sum with interest on a specified day but B dies. In such a case right to demand payment shall rest with B's legal representatives, jointly with C during C's lifetime and after the death of C, with the legal representatives of B and C jointly as 'B' and 'C' both are joint promisees".

The above principle of joint promises is applicable for partners, joint mortgagees and members of a Hindu Undivided Family. In all these cases there is no single promisee. Therefore in order to enforce a promise all the joint promisees should sue the promisor. If any one of the joint promisees refuses to sue the promisor he would not be a plaintiff but be treated as defendant. [*Ashinsa Bibi vs Abdul Kadar* (1902) 25.Mad 26,35, *Mohammed, Isaq vs. Shekh Haq* (1908) 12 C.W.N. 84, 86, 93].

## 1.27 Time and Place for Performance of the Promise

Sections 46 to 50 of the Act deal with this issue of "Time and place" for performance of a promise. Following are the rules of performance where the promisee has not applied for



performance. **Where no time is specified for performance of a promise**, it must be performed within a reasonable time. What is reasonable time would depend on the facts and circumstances of each case [section 46]. **Where a promise is to be performed on a specified date but no time is mentioned**, then it can be performed any time on that day but during business hours only.

A promisee may refuse to accept delivery (of goods), if it is delivered after business hours. For *example* if the promisor wishes to deliver goods at a time which is beyond business hours, the promisee can refuse.

As regards the place of performance, **where no place is fixed for the performance of a promise**, it is the duty of the promisor to ask the promisee to fix a reasonable place. No distinction is made between an obligation to pay money and an obligation to deliver goods or discharge any other obligation. But generally the promise must be performed or goods must be delivered at the usual place of business.

**Where the promisor has not undertaken to perform the promisee without an application by the promisee** and the promise is to be performed on a certain day, it is the duty of the promisee to apply for performance at a proper place and within usual hours of business.

The above are subject to the position that promisor can perform any promise at any place, in any manner, at any time which the **promisee prescribes or sanctions**.

### 1.28 Performance of Reciprocal Promise

The law relating to reciprocal promise as set out in Sections 51 to 54 of the Indian Contract Act, 1872.

**General observation:** A contract may consist of (i) an act and a promise or (ii) two promises one being the consideration for the other.

The second type of contract which involves two promises, one promise from each to the other party is known as "Reciprocal promise". This can be *illustrated* with the following.

When 'A' sells 500 quintals of rice to 'B' and 'B' promises to pay the price on delivery, the contract would consist of two promises one by 'A' to 'B' and another by 'B' to 'A'. These promises are reciprocal promises. Here the promise of 'A' is the consideration for the promise of 'B' and vice versa.

The above is in contrast to another situation. In the above *example* if 'B' promises to pay the price after a month, the contract would have two parts one is the act of 'A' and the second is promise of 'B'. This is not a reciprocal promise.

The performance of reciprocal promise can take in different forms-

(i) **Simultaneously performance of reciprocal promise [Section 51]:** In this case, promises have to be performed simultaneously. The conditions and performances are concurrent. If one of the parties does not perform his promise, the other also need not perform his promise. For *example* where 'A' promises to deliver rice and 'B' promises to pay

the price on delivery, both have to be performed simultaneously. Here both 'A' and 'B' must be willing and ready to perform their accepted part.

**(ii) Performance of reciprocal promise where the order is expressly fixed:** Where the order of performance is expressly fixed, the promise must be performed in that order only. Where 'A' promises to build a house for 'B' and 'B' promises to pay after construction, here 'A' must perform his promise before he can call upon 'B' to fulfill his promise of payment of money. A's performance of the promise is a condition precedent to 'B' performing his part of the promise. Any breach of promise by 'A' would enable 'B' to avoid the contract.

**(iii) Performance of reciprocal promise by implication:** Where the performance of reciprocal promise is not fixed expressly, some times the order is understood by implication. For *example* where 'A' agrees to make over certain stock in trade to 'B' and 'B' agrees to provide certain security for the value of stock in trade, then 'A' need not make over the stock until 'B' provides the security as by implications 'B' is required to perform his part first; otherwise 'A' in the absence of any security will not make over the stock to 'B'.

**(iv) Effect of one party preventing another from performing promise [Section 53]:** When in a contract consisting of reciprocal promises one party prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented. The person so prevented is entitled to get compensation for any loss he may have sustained for the non-performance.

The above can be illustrated with the following *illustrations* by way of two case laws.

- (a) Where there is a contract for sale of standing timber and as per the terms seller is expected to cut and cord the standing timber before the buyer takes delivery but seller cords only a part of it, but neglects to cord the rest of it, then the buyer has a right to avoid the contract and claim compensation for any loss sustained.
- (b) In the well known case of *O'Neil vs. Armstrong*, an Englishman was engaged by the Captain of a Japanese ship to act as fireman on a voyage from England to Japan. During the course of the voyage Japan declared war against China. The Englishman had to leave service because had he continued in service he would have incurred penalties under Foreign Enlistment Act. In effect because of the war, the Englishman was prevented from discharging his part of the contract. The suit filed by him was decreed in his favour in spite of being opposed by the Japanese shipping company. It should be appreciated that the Captain of Japanese ship could not have brought a case against the Englishman for non-performance as the Japanese themselves were responsible for preventing the Englishman from performing his part of the contract.

Sometimes the parties would be prevented from discharging a part of the contract but not the entire contract. In such a case, the party so prevented need not avoid the full contract but perform the rest of it.

**(v) Effects of default as to promise to be performed first:** Section 54 of the Act provides that promises may be such that:

- (i) one of them cannot be performed or
- (ii) its performance cannot be demanded till the other has been performed.

*Example:* Where 'B' a ship owner agrees to convey A's cargo from Calcutta to Mauritius for a freight. Here the beginning part of the transaction is on 'A' as he has to provide the cargo to 'B' to enable 'B' to perform his promise. Thus until cargo is handed over by 'A'. A cannot expect 'B' to perform his promise nor would 'B' be in a position to perform his promise. This peculiar position arises because of default on the part of one of the parties. Here 'B' is entitled to put an end to the contract and claim compensation for any loss he may have suffered.

**(vi) Position of legal and illegal parts of Reciprocal promises:** *Reciprocal promise to do certain things that are legal and certain others that are not legal –*

Section 57 of the Act provides that if reciprocal promises have two parts, the first part being legal and the second part being illegal, the legal part is a valid contract and the illegal part is void.

*Example:* Where 'A' agrees to sell his house to 'B' for ₹ 50000/- and further 'A' insists and it is agreed that if the house is used as a gambling house, then 'B' would pay another ₹ 75000/-. In this case the first part is valid as it is legal, the second part is void as it is illegal.

**(vii) Alternative promise one branch being illegal:** "In the case of the alternative promise, one branch of which is legal and the other illegal, the legal branch alone can be enforced".

For *example*, in the nearest reversionary heir of B, agreed to transfer his inheritance to C, if he succeeded to B; and he did not transfer his own estate to C. It was held that first promise was not enforceable, as it amounted to an agreement to transfer an estate on the mere chance of succession prohibited by Section 6 of the Transfer of Property Act, but the second promise was enforceable under Section 58 as an alternative promise. [*Mahadeo Prasad Singh vs. Mathura* 132 L.C. 321 A]

### 1.29 Effects of Failure to Perform at a Time Fixed in a Contract in which Time is Essential

Section 55 of the Act regulates the position of performance of contract where time is of essence. In terms of this Section, where it is understood between parties that time is an essential element, and where one party is unable to perform his part of the promise either in full or in part within the time specified, then the contract is voidable at the option of the party either in full or in part to the extent of non performance of the contract within the time. In these cases the contract is not voidable if time is not of essence of the contract, but the promisee is entitled for compensation for loss if any suffered on account of such failure.

In a contract where time is of essence and promisor is unable to perform his part within the time, as already stated the contract becomes voidable at the option of the other party. However the other party agrees that the promisor would perform his part subsequently after

the time fixed, the promisee cannot claim any compensation for loss or damage or injury unless he gives any notice to the promisor of his intention to do so.

**The next question for consideration is how to determine whether time is essence of a contract?**

Ordinarily from a plain examination of a contract it would be difficult to ascertain from the terms of the contract whether time is essence of the contract. A promisee may have failed to perform his contract within the specified time. Yet time may not be treated as essence of the contract in that case. Whether time is essence of a contract has to be decided from the terms of the contract.

In mercantile contracts, as business world is ruled by 'time' and 'money' any stipulation as to 'time' and 'money' is an essential condition.

The general principles that are followed can be enunciated as under.

- (i) In transaction on sale of gold, silver, blue chip shares, time of delivery is of essence. Here time will be treated as essence of contract.
- (ii) In transaction involving sale of land, redemption of mortgages, though certain time frame is fixed, any delay is not valued seriously provided justice can be done to parties. Of course even in sale of land, time can be made as on essence of contract by express words.

**Contract cannot be avoided where time is not of essence:** When there is delay in performing promise on executing a contract where the time is not of essence, parties concerned cannot avoid the contract. However in such cases promises must be performed within a reasonable time other wise it becomes voidable at the option of the promisee.

**Effect of acceptance of performance out of time:** Even where time is of essence, the party who is entitled to avoid the contract can waive the condition relating to "performance within time"; but in such cases he cannot claim any compensation for loss if any suffered unless he has put the other party on notice.

#### Key Points

- ◆ Performance of contract- It is the performing of all the promises and fulfilling all the obligations by all the parties as per the term of the contract.
- ◆ Actual performance- When both the parties to a contract perform their promises and nothing remains to be done in future by them.
- ◆ Attempted performance- When tender or offer of performance of goods/ services is not accepted or rejected by the promisee, In such situation the promisor is discharged from his obligation. However, where promisee fails to accept tender of money/price, the promisor is not discharged from his obligation to pay.
- ◆ Contract can be performed by the parties personally, through agent, representative or third party.

- ◆ In case of joint promise- Promisee may compel any of the joint promisors to perform unless otherwise agreed by the parties.
- ◆ Where no time for performance of contract- The contract must be performed within a reasonable time.
- ◆ Where time is essence- Failure to perform the contract at an agreed time will amount to a breach of condition of the contract and will be voidable.
- ◆ Reciprocal promises- Where one promise form the consideration/ part of consideration for each other.

### 1.30 Impossibility of Performance

Agreements become void when it becomes impossible to perform them due to a variety of reasons. This is known as "impossibility of performance" and dealt with by section 56 of the Act

In terms of Section 56 of the Act "An agreement to do an act impossible in itself is void. A contract to do an act which, after the contract is made, becomes impossible, or, (by reason of some event which the promisor could not prevent,) unlawful, becomes void when the act becomes impossible or unlawful.

Where one person has promised to do something which he knew, or with reasonable diligence, might have known, and which the promisee did not know to be impossible or unlawful, such promisor, must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise".

**(1) Impossibility existing at the time of contract:** Even at the time of entering into the agreement, it may be impossible to perform certain contracts at the beginning or inception itself. The impossibility of performance may be known or may not be known to the parties

(i) *If the impossibility is known to the parties :* Where 'A' agrees to pay 'B' ₹ 5000/- to 'B' if he would swim from Bombay in Indian ocean to 'Aden' in 7 days time, this is an agreement where both the parties known that it is impossible to swim the distance between 'Bombay' to 'Aden' in 7 days time and hence is void.

(ii) *If unknown to the parties:* Even where both the promisor and the promisee are ignorant of the impossibility the contract is void.

(iii) *If known only to the promisor:* Where the promisor alone knows it is impossible to perform or even if he does not know but he should have known about the impossibility with reasonable diligence, the promisee is entitled to claim compensation for the loss suffered because of failure of the promisor to perform.

**(2) Supervening impossibility:** When performance of a promise becomes impossible on account of subsequent developments of events or change in circumstances, which are beyond the contemplation of parties, the contract becomes void. Supervening impossibility can arise due to a variety of circumstances as stated below.

(i) *Accidental destruction of the subject matter of the contract* : 'A' had agreed with 'B' to hire for rent his music hall for holiday concerts on certain specified dates. The music hall was destroyed before the specified dates and hence it became impossible to hold stage concerts. It was held that as the music hall ceased to exist; it is a case of supervening impossibility and both the parties were excused from the performance of the contract [*Taylor vs. Caldwell 3B&S826*].

(ii) *Non-existence or non occurrence of a particular state of things*: It was agreed to by the defendant through a contract to have from the plaintiff a flat for specified days for witnessing the coronation procession of King Edward VII. The said procession was cancelled and it did not take place. Therefore the defendant refused to pay the balance rent. It was held that the foundation of the contract had totally failed and here the balance of rent amount cannot be recovered from the defendant. [*Krell vs. Henry 2 KB. 740*]

(iii) *Incapacity to perform a contract of personal services*: In case of contract of personal service, disability or incapacity to perform, caused by an Act of God e.g. illness, constitutes lawful excuse for non-performance of the contract [*Robinson vs. Davison L.R.6Ex.269*]

(iv) *Change in law*: Performance of a contract may also become impossible due to change in law subsequently. The law passed subsequently may prohibit the act which may form part as basis of contract. Here the parties are discharged from their obligations. For *example* 'A' and 'B' may agree to start a business for sale of lottery and contribute capital for the business. If the business of sale of lottery ticket is banned by a subsequent law, parties need not keep up their legal obligations.

(v) *Outbreak of war*: Out break of war may affect the enforceability of contracts in many ways like

- (a) emergency legislations controlling prices
- (b) relaxation of trade restrictions and
- (c) prohibiting or restraining transaction with alien enemy.

**Doctrine of Frustration:** The idea of "supervening impossibility" is referred to as 'doctrine of frustration' in U.K. In order to decide whether a contract has been frustrated, it is necessary to consider the "intention of parties as are implied from the terms of contract".

However in India the 'doctrine of frustration' is not applicable. Impossibility of performance must be considered only in term of section 56 of the Act. Section 56 covers only 'supervening impossibility and not implied terms'. This view was upheld by Supreme Court in *Satyabrata Ghose vs Mugneeram Bangur A.I.R.(1954) S. C. 44* and *Alopi Prasad vs Union of India A.R. 1960 S.C.588*.

**What would not constitute ground of impossibility:** Various decisions which have identified certain situations as not constituting grounds of impossibility -

- (a) 'A' promised to 'B' that he would arrange for 'B's marriage with his daughter. 'A' could not persuade his daughter to marry 'B'. 'B' sued 'A' who pleaded on the ground of

impossibility that he is not liable for any damages. But it was held that there was no ground of impossibility. It was held that 'A' should not have promised what he could not have accomplished. Further 'A' had chosen to answer for voluntary act of his daughter and hence he was liable.

- (b) The defendant agreed to supply specified quantity of 'cotton' manufactured by a mill within a specified time to plaintiff. The defendant could not supply the material as the mill failed to make any production at that time. The defendant pleaded on the ground of impossibility which was not approved by the Privy Council and held that contract was not performed by the defendant and he was responsible for the failure. [*Hamandrai vs Pragdas 501A*]
- (c) The defendant agreed to procure cotton goods manufactured by Victoria Mills to plaintiff as soon as they were supplied to him by the mills. It was held by Supreme Court that the contract between defendant and plaintiff was not frustrated because of failure on the part of Victoria Mills to supply goods [*Ganga Saran vs Finn Rama Charan, A.I.R 1952 S.C.9*]
- (d) A dock strike would not necessarily relieve a labourer from his obligation of unloading the ship within specified time.
- (e) In *Satyabrat Ghosh vs Mugneeram Bangur & Co. A.I.R 1954 S.C.44*, Calcutta High court held in a context of impossibility of performance that "having regard to the actual existence of war condition, the extent of the work involved and total absence of any definite period of time agreed to the parties, the contract could not be treated as falling under impossibility of performance. In the given case the plaintiff had agreed to purchase immediately after outbreak of war a plot of land. This plot of land was part of a scheme undertaken by the defendant who had agreed to sell after completing construction of drains, roads etc. However the said plot of land was requisitioned for war purpose. The defendant thereupon wrote to plaintiff asking him to take back the earnest money deposit, thinking that the contract cannot be performed as it has become impossible of being performed. The plaintiff brought a suit against the defendant that he was entitled for conveyance of the plot of land under condition specified in the contract. It was held that the requisition order did not make the performance impossible.

While judging the impossibility of performance issue, the Courts would be very cautious since contracting parties often bind themselves to perform at any cost of events without regard to price prevailing and market conditions.

**Key Points:**

A contract is discharged by impossibility of its performance.

- ◆ Impossibility may be of two types :
  - (i) Initial Impossibility-existed at the time of making the agreement.
  - (ii) Subsequent or supervening impossibility-arises after formation of contract.
- ◆ The contract becomes void when the performance of the contract becomes impossible.

- ◆ Doctrine of frustration applies in the case of supervenning impossibility, where- the performance of contract has become impossible, and where the object of the contract has failed.
- ◆ This doctrine does not apply- where the performance simply becomes difficult /commercially impossible/ impossibility induced by the act or the conduct of any person etc.

### 1.31 Appropriation of Payments

Where a person [Debtor] owes a number of debts to another person [Creditor], and when he releases certain payments, then the question arises as to how to adjust the receipt against so many dues. This issue is considered and answered in Sections 59, 60 and 61 of the Act under the heading 'Appropriation of payments'.

(i) **Application of payment where debt to be discharged is indicated:** In term of section 59 of the Act "Where a debtor, owing several distinct debts to one person, makes a payment to him either with express intimation or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly".

Where a debtor owes a number of debts and he pays an amount with express or implied instructions towards appropriation, the debtor is at will to appropriate to any debt and the creditor is bound by it. This is set out in the Latin Maxim of "*quicquid sovitur, sovit sectionundum modum solventis*" meaning that whatever is paid, is paid according to intention or manner of party paying. The right of debtor to decide the appropriation is also known as decision in *Clayton's case*.

What is the position if the debtor does not expressly state the method of appropriation? Then we have to go by the circumstances of the case. For *example* a debtor who owes among other debts ₹ 2000/- to a creditor and pays ₹ 2000/- on a given day when the debt of ₹ 2000/- falls due, then the amount must be accordingly applied and the debt be discharged accordingly.

(ii) **Application of payment where debt to be discharged is not indicated:** "Where the debtor has omitted to intimate and there are no other circumstances indicating to which debt the payment is to be applied, the creditor may apply it at his discretion to any lawful debt actually due and payable to him from the debtor whether its recovery is or is not barred by the law in force for the time being as to the limitation of suits".

From the above it can be seen that the creditor enjoys the right to appropriate even to a debt which is barred by limitation.

It was held by Lord Macnaughten in *Cory Bros. & Co. vs. Owner of the Mecca (1817) A.C.286 & 293*, that if the debtor does not make any appropriation, at the time of payment, the right devolves on the creditor. Creditors have a right to decide till the very last moment. The above



decision was followed in a number of important cases including in the famous case of *Vinkatadri Appa Rao vs Parthasarathi Appa Rao* [(1921) L.R. 48. I.A. 150; 44 Mad 570 and 573.. In the said case it was held that creditor can decide at his discretion on the appropriation of payment towards any lawful debt even if barred by limitation. If there is any debt carrying interest and if there are no express or implied instructions the amount paid should be appropriated towards payment of interest and then to capital.

(iii) **Application of payment when neither party appropriates:** In terms of section 61 of the Act, where neither party appropriates-

- (a) the payment shall be applied in discharge of debts in order of time, and
- (b) if the debts are of equal standing the payment shall be applied in discharge of each proportionately.

The above appropriation takes place whether or not the debt is barred by limitation.

For *example* where there are two debts one ₹ 500/- and another ₹ 700/- falling due on the same day, and if the debtor pays ₹ 600/- the appropriation shall be prorata of ₹ 250/- and ₹ 350/- for the two debts.

### 1.32 Contract, Which Need not be Performed

A contract would not require performance under circumstances spelt out in Sections 62 to 67 of the Act. These circumstances are (i) novation, (ii) rescission, (iii) alteration and (iv) remission.

Section 62 of the Act provides that "if the parties to a contract agree to substitute a new contract for it or to rescind or alter it, the original contract need not be performed".

(a) **Effect of novation:** Novation means substitution. Where a given contract is substituted by a new contract it is novation. The old contract, on novation ceases. It need not be performed. Novation can take place with mutual consent. However novation can take place by substitution of new contract between the same parties or between different parties. Novation results in discharge of old contract. This can be *illustrated* as follows -

A owes money to B under a contract. It is agreed between A, B and C that B shall thenceforth accept C as his debtor, instead of A. The old debt of A to B is at an end, and a new debt from C to B has been contracted.

(b) **Effect of rescission:** In case of rescission, the old contract is cancelled and no new contract comes in its place. A contract is also discharged by rescission. Some times parties may enter into an agreement to rescind the previous contract. Sometimes, the contract is rescinded by implication or by non- performance for a long time without each other complaining about it.

**Difference between novation and rescission:** While novation involves rescission, there is no novation in rescission. Both in novation and rescission the contract is discharged by mutual agreement. In both cases parties enter into a new contract to come out of the old contract.

The new agreement is the consideration for rescission.

(c) **Effect of alteration:** Where the contract is altered, the original contract is rescinded. Hence the old one need not be performed whereas the new one has to be performed. Alteration involves both rescission and novation. The line of difference between alteration and novation is very thin. While there can be very minor alterations, there can not be unilateral material alteration to a contract. If it is done it will be void.

**Novation and alteration:** Both in novation and in alteration the old contract need not be performed.

The main difference between the two are:

Novation	Alteration
Novation involves changes in the terms of contract. It also sometimes means change in the parties to contract. It infact operates as a substitution of the old contract.	In alteration there are only changes in the term of contract by mutual consent. The parties to contract remain the same. There is no substitution of old terms; only some terms and conditions change. There are remission of performance in alteration.

Remission means waiver. Section 63 of the Act deals with remission. It provides that "every promisee may dispense with or remit wholly or in part, the performance of the promise made to him or may extend the time for such performance or may accept instead of it any satisfaction which it thinks fit". Thus the promisee can waive either in full or in part the obligation of the promisor or extend the time for performance. For *example* where 'A' owes 'B' a sum of ₹ 1 lakh, 'B' may accept a part of it in full and final settlement of the due or waive his entire claim.

While granting the time to the promisor, the promisee cannot do so for his benefit but can do so only for the benefit of the promisor. For *example* where 'A' promises 'B' that he would deliver certain goods by a certain date, 'B' can extend the time but he cannot take advantage to charge interest on the extended time.

Similarly a promisee can accept any other performance to his satisfaction instead of the specified stipulated performance.

For *example* where A promises to sell his horse for a consideration of ₹ 5000/- to 'B', 'A' may instead of cash consideration of ₹ 5000/- may accept jewellery worth Rs 5,000/- in full satisfaction of the consideration. In a situation like this the essential element of 'satisfaction' is that the promisee must accept the consideration unequivocally. If a promisor tenders some thing in full satisfaction but the promisee does not accept it or accepts in part performance, such satisfaction will fall outside the ambit of section 63 of the Act. [*Shyamnagar tin Factory vs Snow White Food Products, A.I.R (1965) Cal 54*]

It should be noted that novation, rescission or alteration cannot take place without consideration but in case of part or complete rescission no consideration is required. The promisee can dispense with performance without consideration and without a new agreement.

### 1.33 Restoration of Benefit under a Voidable Contract

It has already been seen that certain contracts referred to in Sections 19, 19A, 39, 51, 54 & 55 are voidable. The question for consideration is what is the effect of rescission of contract by that person at whose option the contract is voidable. The following are the effects of such an action-

- (i) The other party need not perform the promise
- (ii) Any benefit received by the person rescinding it must restore it to the person from whom it was received.

A voidable contract which is voidable either at its inception or subsequently comes to an end when it is avoided by the party at whose option it is avoided. In such a case, not only the contract need not be performed there is also restoration of benefit.

- (a) the injured party on account of non performance of the contract is entitled to recover compensation for damages suffered and
- (b) benefits received must be restored.

In *Murlidhar vs. International Film Co.* A.I.R 1943 P.C. 34, the plaintiff having wrongfully repudiated the contract, the defendants rescinded it u/s 39 of the Act. The plaintiff brought a suit to recover ₹ 4000/- paid to the defendant. Held defendant was bound to restore the amount after setting off such damages.

When an insurance company has rescinded the policy because the policy holder could not disclose material information, it should refund the premium after making necessary adjustments for expenses already incurred.

### 1.34 Obligations of Person who has Received Advantage under Void Agreement or one Becoming Void.

In terms of section 65 of the Act, where

- (a) an agreement is discovered to be void or
- (b) a contract becomes void

any person who received an advantage must

- (a) restore it or
- (b) pay compensation for damages in order to put the position prior to contract.

In *Dhuramsey vs. Ahgmedhai (1893) 23 Bom 15*, the plaintiff hired a godown from the defendant for 12 months and paid the advance in full. After about seven months the godown was destroyed by fire, without any fault on the part of plaintiff. When the plaintiff claimed refund of the advance, it was upheld that he was entitled to recover the rent for the unexpired term.

The next issue is the benefit which has to be returned must have been received under the contract. Any benefit received which is ancillary to main contract need not be returned. For example, the deposit paid for a transaction of sale of house between parties, need not be returned just because the sale transaction could not take place. This was on the ground that the deposit is only a security and not part of main contract.

### 1.35 Discharge of a Contract

A contract may be discharged in eight ways as discuss hereunder.

**(a) Discharge by performance:** Discharge by performance will take place when there is (i) Actual performance or (ii) Attempted performance

Actual performance / discharge takes place when parties to the contract fulfill their obligations within time and in the manner prescribed. Here each party has done what he has to do under the contract. In attempted performance the promisor offers to perform his part but the promisee refuses to accept his part. This is also known as tender.

**(b) Discharge by mutual agreement:** Discharge also takes place where there is substitution [novation] rescission, alteration and remission. In all these cases old contract need not be performed.

**(c) Discharge by impossibility of performance:** A situation of impossibility may have existed at the time of entering into the contract or it may have transpired subsequently (also known as supervening impossibility)

Impossibility can arise when

- (i) there is an unforeseen change in law.
- (ii) destruction of subject matter.
- (iii) non-existence or non occurrence of a state of thing to facilitate happening of the agreement.
- (iv) personal incapacity of the promisor.
- (v) declaration of war.

**(d) Discharge by lapse of time:** Performance of contract has to be done within certain prescribed time. In other words it should be performed before it is barred by law of limitation. In such a case there was no remedy for the promisee. For *example*, where then the debt is barred by law of limitation.

**(e) Discharge by operation of law:** Where the promisor dies or goes insolvent there is a discharge by operation of law.

**(f) Discharge by breach of contract:** Where there is a default by one party from performing his part of contract on due date then there is breach of contract. Breach of contract can be actual breach or anticipatory breach. Where a person repudiates a contract before the stipulated due date, it is anticipatory breach. In both the events, the party who has

suffered injury is entitled for damages. Further he is discharged from performing his part of the contract.

(g) A promisee may remit the performance of the promise by the promisor. Here there is a discharge. Similarly the promisee may accept some other satisfaction. Then again there is a discharge on the ground of accord and satisfaction

(h) When a promisee neglects or refuses to afford the promisor reasonable facilities or opportunities for performance, promisor is excused by such neglect or refusal.

#### Key Points

- ◆ Performance of contract leads to discharge of contract. There are other alternative methods of discharge where a contract would not require performance. These circumstances are (i) novation, (ii) rescission, (iii) alteration and (iv) remission. A contract may also be discharged by agreement of the parties or by lapse of time for performance or by operation of law, or impossibility of performance or by breach of contract.
- ◆ A voidable contract which is voidable either at its inception or subsequently comes to an end when it is avoided by the party at whose option it is avoided. In such a case, no contract need to be performed but there is a restoration of benefit.
- ◆ Any agreement which is discovered to be void or a contract which becomes void, there any person who received an advantage must restore it or pay compensation for damages in order to put the position prior to contract.

## UNIT – 5 : BREACH OF CONTRACT

### Learning objectives

After studying this unit, you would be able to -

- ◆ Understand the concept of breach of contract and various modes thereof.
- ◆ Understand the rule laid down in '*Hadley vs. Baxendale*' for award of compensation.
- ◆ Be clear about how the damages are to be measured.
- ◆ Note the circumstances when vindictive damages are awarded.

Let us now examine breach of contract and the methodology for estimation of compensation for such breach of contract.

### 1.36 Anticipatory Breach of Contract

Where the promisor refuses to perform his obligation even before the specified time for performance and signifies his unwillingness, then there is an anticipatory breach.

Leading case on this point is *Hochester vs. De La Tour* (1853) 2 E & B 678. In this case defendant had engaged the services of plaintiff as his attendant for a tour of the continent from June 1<sup>st</sup> on a fee of £10 per month for three months. However defendant changed his mind before June 1<sup>st</sup> and informed the plaintiff that his services are not required. This is thus a case of anticipatory breach of contract. It was held in this case that plaintiff could put an end to the contract even before the due date viz 1<sup>st</sup> June and he need not wait for the date meant for performance of the promise.

The principle of anticipatory breach was well summed up in *Frost vs. Knight* (1872) LR 7 Ex. 111. In the above case it was held that promisee could wait till the due date of performance also before he puts an end to the contract. In such a case the amount of damages will vary depending on the circumstances. This can be explained with the following illustration: 'X' agrees to sell 'Y' certain quantity of wheat at a certain price. viz @ ₹ 100/- per quintal by 3<sup>rd</sup> March. However on 2<sup>nd</sup> February X gives notice of his unwillingness to sell the given goods. Price of wheat on that date is ₹ 110/- per quintal. 'Y' has a right to repudiate the contract on the same day instead of waiting for the date of performance. On that day 2<sup>nd</sup> February, he is entitled to recover damages of ₹ 10/- per quintal this being the difference between market price and contracted price. If on the other hand, he chooses to wait till 3<sup>rd</sup> March and the price on that date is ₹ 125/-, he can recover damages @ ₹ 25/- per quintal. The third possibility is that if between 2<sup>nd</sup> February and 3<sup>rd</sup> March, Government prohibits sale of wheat, then the contract becomes void and Y will not be able to recover any damage whatsoever. Hence from this illustration it would be clear that when the promisee postpones his right to repudiate the promise, it would operate to the advantage of the promisor also depending on circumstances.

### 1.37 Actual Breach of Contract

Where one of the parties breaches the contract by refusing to perform the promise on due date, it is known as actual breach of contract. In such a case the other party to contract obtains a right of action against the one who breached the contract.

### 1.38 Measurement of Damages

In cases where there is a breach of contract, the promisor who breaches is liable to pay compensation for damages suffered by the promisee. The compensation can be classified as:

- (i) those for damages that usually arise in the event of breach of contract and
- (ii) those for damages which parties know and anticipated at the time of entering into the contract called special damages. This kind of special damages can be claimed only on previous notice.

However no compensation is payable for any remote or any indirect loss. While assessing the damage the inconvenience caused to the aggrieved party on account of non-performance should be assessed carefully, as the party entitled for compensation, he has a duty to take steps to minimise the loss.

The rules relating to compensation were enunciated in detail in *Hadley vs. Baxendale (1854) 9 Ex. 341*. In this case, the mill of the plaintiff had to be stopped because of a broken crank shaft. The plaintiff sent the crank shaft as a pattern for manufacturing a new one. Till the arrival of the new crank shaft, the mill could not be resumed. Hence mill incurred losses. However this position was not properly conveyed to the defendant, the carrier. There were some delay on the part of the defendant in delivering the crank shaft to the manufacturer which in turn delayed the reopening of the mill. As a result of this, there were losses to the mill. The defendant claimed compensation for loss in profit of the mill. However this was not accepted by court on the ground the plaintiff did not explain to defendant that delay in delivering the crank shaft would delay resumption of the mill and this would result in losses to the plaintiff.

Madras High Court in *Madras Railway Company vs. Govind Ram, Mad. 176* upheld the same principle as above. In that case a tailor had given his sewing machine to railways to be delivered at a station as a consignment. He did not mention that any delay in delivering the sewing machine would result in damages for the business of the tailor as he had planned to do good business at the place proposed where a festival was to be held. The sewing machine was delivered after the festival was over. Held Railways were not responsible for the damages as the Railway authorities were not informed of the specific purpose of delivery of the sewing machine namely business during a festival.

### 1.39 Liability for Damages

The liability to pay damages is of four kinds. They are:

- (i) liability for special damages
- (ii) liability for exemplary damages
- (iii) liability to pay nominal damages and
- (iv) liability to pay damages for deterioration caused by delay.

Now let us discuss each one of them-

**(i) Liability for special damages:** Where it is understood between parties that in the event of breach of contract, there would be special damages also in addition to normal damages, then special damages would be payable. In our given *example* above if the tailor had informed about the special circumstances, special damages would have become payable.

**(ii) Liability for exemplary damages:** These situations may arise mainly in two cases namely (i) breach of promise to marry and (ii) wrongful dishonour of cheques of customer by bank.

In case of breach of promise to marry the damages are awarded taking into account the injury or humiliation which the aggrieved person would have suffered.

In case of wrongful dishonour of cheques the damages would depend upon the loss of credit and reputation suffered by the customer. The damages could be very heavy if loss had been suffered by a businessman, when compared to a non-businessman customer. For example Mrs. G, a non-trader paid a cheque for £90 and 16 shillings drawn on Westminster Bank to her landlord for rent. The cheque was dishonoured by the bank. But she was awarded damages of only 40 shilling as nominal damages. [*Gibbons vs. Westminster Bank (1939) 2 K.B. 882*]

Similarly where the value of cheque is small the damages could be very heavy in comparison to a situation where the value of cheque is heavy. This is on the theory that dishonour of a small value of cheque would cause more damages to the honour of the customer.

**(iii) Liability to pay nominal damages:** Nominal damages are awarded in those cases of breach of contract where no damage has been suffered. Such damages are awarded only to establish the right to decree for breach of contract. Such damages are for nominal amounts like ten rupees or even ten paise.

**(iv) Damages for deterioration caused by delay:** Compensation can be recovered even without notice for damages or 'deterioration' caused to goods on account of delay by carriers amounting to breach of contract. Here the word "deterioration" means not only physical damages but also loss of opportunity. In *Wilson vs. Lancashire and Yorkshire Railway Company 50 LJCP 232*, the plaintiff bought velvet with a view to making it into caps for sale during spring. But due to delay in transit, he was unable to use the velvet for making caps for sale during season.



It was held that the fall in value of sale of cloth in consequence of the same having arrived after the season amounted to deterioration. It was here held that the plaintiff is entitled for compensation without notice.

#### 1.40 How to Calculate the Damage

In case of a contract for sale of good- (i) where the buyer breaks the contract, the damages would be the difference between contract price and market price as on the date of breach. (ii) where the seller breaks the contract, the buyer can recover the difference between market price and contract price as on date of breach.

Where if the seller retains the goods after the contract has been broken by the buyer- there the seller cannot recover from the buyer any further loss even if the market falls. Again he is not liable to have the damages reduced if the market rises.

In *Jamal vs. Mulla Dawood (1961) 43.I.A. 6*, the defendant agreed to purchase from the plaintiff, certain shares on December 30, but wrongfully rejected them when tendered on date. The difference between the contract price and market price amounted to ₹ 1,09,218; the plaintiff recovered a part of the loss by selling those shares in a rising market and the actual loss amounted to ₹ 79,882. The plaintiff, however, sued the defendant claiming ₹ 1,09,218 as damages and the Privy Council allowed the claim in full.

**Duty to mitigate loss:** The person who suffers losses on account of breach of contract by the other party must take all reasonable steps to mitigate the loss.

#### 1.41 Compensation for Breach of Contract where the Penalty is stipulated for

The compensation for breach of contract falls into two broad categories namely liquidated damage and penalty.

**Liquidated damage** is a genuine pre-estimate of compensation for damages for certain anticipated breach of contract. This estimate is agreed to between parties to avoid at a later date detailed calculations and the necessity to convince outside parties.

**Penalty** on the other hand is an extravagant amount stipulated and is clearly unconscionable and has no comparison to the loss suffered by the parties.

In terms of Section 74 of the Act "where a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach, can claim whether or not actual damages or loss is proved to have been caused thereby, from the other party, a reasonable compensation not exceeding the amount so named, or as the case may be the penalty stipulated for.

Any stipulation for payment of increased interest is a stipulation for payment of penalty which has to be paid.

In terms of Section 74, courts are empowered to reduce the sum payable on breach whether it is 'penalty' or "liquidated damages" provided the sum appears to be unreasonably high.

Supreme Court in *Sri Chunni Lal vs. Mehta & Sons Ltd. A.I.R.1962 S.C. 1314* laid down the ratio that the aggrieved party should not be allowed to claim a sum greater than what is specific in the written agreement. But even there the court has powers to reduce the amount if it considers it reasonable to reduce.

**Liquidated damages and penalty:** Following are the important differences between liquidated damages and penalty.

Liquidated damages	Penalty
Imposed by way of compensation	Imposed by way of punishment
It is an assessed amount of loss based on actual or probable calculation	It is not based on actuals or probables. It is imposed to prevent parties from committing the breach.
English Law recognizes the difference between the two (liquidated damages & penalty)	Section 74 of the act does not recognize any difference between the two (liquidated damages & penalty)

Apart from claiming damages for breach of contract, the following other remedies are also available.

(i) **Rescission of contract:** Where one party breaches the contract, the other party can treat it as rescinded. In this case the other party is absolved of his obligation and is entitled to compensation for damages which he suffered.

(ii) **Suit upon quantum meruit:** The phrase 'quantum meruit' literally means "as much as earned" or "according to the quantity of work done". A person who has begun a civil contract work and has to later stop the work because the other party has made the performance impossible, is entitled to receive compensation on the principle of 'Quantum Meruit'.

Following are instances where 'quantum meruit' may arise:

- (a) Where the work has been done and accepted under a contract which is subsequently discovered to be void. In such a case, the person who has performed his part of the contract is entitled to recover the amount for the work done and the party, who receives and accepts the benefit under such contract, must make compensation to the other party.
  - (b) Where a person does some act or delivers something to another person with the intention of receiving payment, the other person is bound to make payment if he accepts such services or goods or enjoys the benefits.
  - (c) Where the contract is divisible and where a party performs a part of the contract and refuses to perform the remaining part, the party in default may sue the other party who enjoyed the benefit of the part performance.
- (iii) **Suit for specific performance:** Where damages are not an adequate remedy in the

case of breach of contract, the court may in its discretion on a suit for specific performance direct the party in breach, to carry out his promise according to the terms of the contract.

#### Key Points

- ◆ Breach of contract means failure or refusal of any one party to perform his contractual obligations under the contract. It is either actual or anticipatory breach of contract.
- ◆ Actual Breach-Failure/refusal of any one party to perform his contractual obligations under the contract when it is due. Here the contract is voidable.
- ◆ Anticipatory breach of contract- Where the promisor refuses to perform his obligation even before the specified time for performance and signifies his unwillingness, then there is an anticipatory breach. Here the aggrieved party may immediately treat the contract voidable or wait till the time when the performance is due.
- ◆ Aggrieved party has following remedies on the breach of contract- Rescission of the contract, suit for damages, suit for quantum meruit, specific performance and for injunction.
- ◆ Rescission- Cancellation of a contract by the consent of all parties/ by aggrieved party.
- ◆ Damages- Monetary compensation payable to the injured party for the loss due to breach of contract by the defaulted party.
- ◆ Liquidated Damages-Pre-estimated amount of a damages that are mentioned in a contract and are paid on the breach of contract.
- ◆ Penalty-Amount specified in a contract which is high and disproportionate from the amount of damages in the event of its breach. This amount is paid as of punishment to avoid the breach of contract.

## UNIT – 6: CONTINGENT AND SPECIAL CONTRACTS

### Learning objectives

After studying this unit, you would be able to -

- ◆ Have clarity about the basic characteristics of 'Contingent contract' and 'Quasi-contract' so that you are able to distinguish between a contract of any of these types and a simple contract.
- ◆ Be familiar with the rules relating to enforcement of these in order to gain an understanding of rights and obligations of the parties to the contract.

In this unit we shall briefly examine

- (a) 'Contingent contracts' and the rules regarding their enforceability and
- (b) Quasi contracts

### 1.42 Contingent Contract

In terms of Section 31 of the Act contingent contract is a contract to do or not to do something, if some event collateral to such contract does or does not happen. Contracts of indemnity and contracts of insurance fall under this category.

For *instance* if 'A' contracts to pay 'B' ₹ 100000/- if B's house is destroyed by fire then it is a contingent contract.

#### Essentials of a contingent contract

- (a) The performance of a contingent contract would depend upon the happening or non-happening of some event or condition. The condition may be precedent or subsequent
- (b) The event referred to is collateral to the contract. The event is not part of the contract. The event should be neither performance promised nor a consideration for a promise.

Where 'A' agrees to deliver 100 bags of wheat and 'B' agrees to pay after delivery, this is a conditional contract and not a contingent contract. Similarly where 'A' promises to pay 'B' ₹ 10000/- if he marries 'C' is not a contingent contract but a conditional contract.

- (c) The contingent event should not be a mere 'will' of the promisor. The event should be contingent in addition to being the will of the promisor.

For *example* if 'A' promises to pay 'B' ₹ 10000/- if 'A' left for Delhi from Mumbai on a particular day, it is a contingent contract because though 'A's leaving for Delhi is his own will, it cannot happen only at his will.

### 1.43 Rules Relating to Enforcement

The rules relating to enforcement of a contingent contract are laid down in sections 32, 33, 34 and 36 of the Act.

(a) **Contingency is the “happening of an event”:** Where a contract identifies happening of a future contingent event, the contract cannot be enforced until and unless the event ‘happens’. If the happening of the event becomes impossible, then the contingent contract is void. For *instance* ‘X’ enters into a contract to buy ‘Y’s car provided ‘Y’ survives ‘A’. Here ‘Y’ surviving ‘A’ or ‘A’ dying before ‘Y’ is the event on which the contract is contingent and they cannot be enforced until ‘A’ dies.

(b) **Contingency is the non-happening of an event:** Where a contingent contract is made contingent on a non-happening of an event, it can be enforced only when its happening becomes impossible. For *example* where ‘P’ agrees to pay ‘Q’ a sum of money if a particular ship does not return, the contract becomes enforceable only if the ship sinks so that it cannot return.

(c) **Contingent on the future conduct of a living person:** A contract would cease to be enforceable if it is contingent upon the conduct of a living person when that living person does some thing to make the ‘event’ or ‘conduct’ as impossible of happening. For *example* where ‘A’ agrees to pay ‘B’ a sum of money if ‘A’ marries ‘C’. ‘C’ marries ‘D’. This act of ‘C’ has rendered the event of ‘A’ marrying ‘C’ as impossible; it is though possible if there is divorce between ‘C’ and ‘D’.

(d) **Contingent on an impossible event:** A contingent agreement to do a thing or not to do a thing if an impossible event happens is void and hence is not obviously enforceable. The situation would not change even if the parties to the agreement are not aware of such impossibility. ‘A’ agrees to pay ‘B’ ₹ one lakh if sun rises in the west next morning. This is an impossible event and hence void.

#### **Difference between a contingent contract and a wagering contract**

1. A wagering agreement is a promise to give money or money's worth with reference to an uncertain event happening or not happening.  
A contingent contract is a contract to do or not to do something with reference to a collateral event happening or not happening.
2. A wagering agreement consists of reciprocal promises whereas a contingent contract may not contain reciprocal promises.
3. In a wagering contract the uncertain event is the core factor whereas in a contingent contract the event is collateral.
4. A wagering agreement is essentially contingent in nature whereas a contingent contract may not be wagering in nature.
5. In a wagering agreement, the contracting parties have no interest in the subject matter whereas it is not so in a contingent contract.
6. A wagering contract is a game, losing and gaining alone matters whereas it is not so in a contingent contract.
7. A wagering agreement is void where as a contingent contract is valid.

**Key Points**

- ◆ A contract may be either absolute or contingent.
- ◆ Contingent contract- Where the promisor undertakes to perform the contract which is depended on the happening/ non-happening of a specified future uncertain event, which is collateral to the contract. Also termed as conditional contract because of its uncertain nature.
- ◆ Contract of indemnity, guarantee and insurance are contingent contracts, even LIC to a certain extent is contingent contract.
- ◆ All wagering agreements are basically contingent agreements but all the contingent contracts are not wagering agreements.

**1.44 Quasi – Contracts**

Even in the absence of a contract, certain social relationships give rise to certain specific obligations to be performed by certain persons. These are known as quasi contracts as they create same obligations as in the case of regular contract.

Quasi contracts are based on principles of equity, justice and good conscience.

**Salient features of quasi contracts are:**

- (a) In the first place, such a right is always a right to money and generally, though not always, to a liquidated sum of money.
- (b) Secondly, it does not arise from any agreement of the parties concerned, but it imposed by the law; and
- (c) Thirdly, it is a right which is available not against all the world, but against a particular person or persons only, so that in this respect it resembles a contractual right.

**1.45 Types of Quasi Contract**

There are five circumstances which are identified by the Act as quasi contracts. These five circumstances do not result in regular contracts.

**(a) Claim for necessities supplied to persons incapable of contracting:** Any person supplying necessities of life to persons who are incapable of contracting is entitled to claim the price from the other person's property. Similarly where money is paid to such persons for purchase of necessities, reimbursement can be claimed.

For *example* if 'A' supplies necessities of life to 'B' a lunatic or to his wife or child whom 'B' is liable to protect and maintain, then 'A' can claim the price from the property of 'B'. For such claim to be valid 'A' should prove the supplies were to the actual requirements of 'B' and his dependents. No claim for supplies of luxury articles can be made. If 'B' has no property 'A' obviously cannot make his claim.

**(b) Right to recover money paid for another person:** A person who has paid a sum of money which another is obliged to pay, is entitled to be reimbursed by that other person provided the payment has been made by him to protect his own interest.

Here the person who makes the payment must honestly believe that his own interest demands payment. [*Muni Bibi vs. Trilokinath*].

In a case the plaintiff agreed to purchase certain mills and to save it from being sold to outsiders paid certain arrears of municipal dues. Here the payment made by the plaintiff was held to be recoverable as he had interest in the property as prospective buyer.

**(c) Obligation of person enjoying benefits of non-gratuitous act:** In term of section 70 of the Act "where a person lawfully does anything for another person, or delivers anything to him not intending to do so gratuitously and such other person enjoys the benefit thereof, the latter is bound to pay compensation to the former in respect of, or to restore, the thing so done or delivered.

The above can be illustrated by a *case law* where 'K' a government servant was compulsorily retired by the government. He filed a writ petition and obtained an injunction against the order. He was reinstated and was paid salary but was given no work and in the mean time government went on appeal. The appeal was decided in favour of the government and 'K' was directed to return the salary paid to him during the period of reinstatement. [*Shyam Lal vs. State of U.P. A.I.R (1968) 130*]

**(d) Responsibility of finder of goods:** In terms of section 71 'A person who finds goods belonging to another and takes them into his custody is subject to same responsibility as if he were a bailee'.

Thus a finder of lost goods has:

- (i) to take proper care of the property as men of ordinary prudence would take
- (ii) no right to appropriate the goods and
- (iii) to restore the goods if the owner is found.

Where 'P' a customer in 'D's shop puts down a brooch worn on her coat and forgets to pick it up and one of 'D's assistants finds it and puts it in a drawer over the week end. On Monday, it was discovered to be missing. 'D' was held to be liable in the absence of ordinary care which a prudent man would have taken.

**(e) Liability for money paid or thing delivered by mistake or by coercion:** In terms of Section 72 of the Act, "a person to whom money has been paid or any thing delivered by mistake or under coercion, must repay or return it. Every kind of payment of money or delivery of goods for every type of 'mistake' is recoverable. [*Shivprasad vs Sirish Chandra A.I.R. 1949 P.C. 297*]

A payment of municipal tax made under mistaken belief or because of mis- understanding of the terms of lease can be recovered from municipal authorities. The above law was affirmed

by Supreme Court in cases of *Sales tax officer vs. Kanhaiyalal A.I.R. 1959 S.C.835*

Similarly any money paid by coercion is also recoverable. The word coercion is not necessarily governed by section 15 of the Act. The word is interpreted to mean and include oppression, extortion, or such other means [*Seth Khanjelek vs National Bank of India*].

In a case where 'T' was traveling without ticket in a tram car and on checking he was asked to pay ₹ 5/- as penalty to compound transaction. T filed a suit against the corporation for recovery on the ground that it was extorted from him. The suit was decreed in his favour. [*Trikamdas vs. Bombay Municipal Corporation A.I.R. 1954*]

In all the above cases the contractual liability arose without any agreement between the parties.

#### Key Points

- ◆ Quasi contracts / Constructive contracts are the contract presumed by law. These are the contracts which are imposed by law and the Act describes such contract as "Certain relations resembling those created by contracts".
- ◆ Quasi contract may be exercised under following five conditions-
  - Necessaries of life supplied to incapable person and to his dependents.
  - Person pays money on behalf of the one, who is legally bound to pay.
  - Person enjoying the benefits of non-gratuitous act.
  - Person finds goods belonging to other.
  - Person to whom money has been paid or anything delivered by mistake or under coercion.



### UNIT – 7 : CONTRACT OF INDEMNITY AND GUARANTEE

#### Learning objectives

After studying this unit, you would be able to –

- ◆ Be conversant with the two special type of contracts i.e. Indemnity contracts and Guarantee contracts and also the nature of obligations and rights of each of the parties to the contracts.
- ◆ Be clear about distinction between these contracts.

Contract of Indemnity and Guarantee are the special types of contracts given under sections 124 to 147 of the Indian Contract Act, 1872.

In this unit, the law relating to indemnity and guarantee are discussed.

#### 1.46 Contract of Indemnity

In terms of Section 124 of the Act, 'a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or the conduct of any person is called a "contract of indemnity". This is also known as typical form of contingent contract.

There are two parties in this form of contract. The party who promises to indemnify/ save the other party from loss is known as 'indemnifier', where as the party who is promised to be saved against the loss is known as 'indemnified'.

For *examples*, (1) A may contract to indemnify B against the consequences of any proceedings which C may take against B in respect of a sum of ₹ 5000/- advanced by C to B. In consequence, when B who is called upon to pay the sum of money to C fails to do so, C would be able to recover the amount from A as provided in Section 124.

(2) X, a shareholder of a company lost his share certificate. He applied for the duplicate. The company agreed to issue the same on the term that X will compensate the company against the loss where any holder produces the original certificate. Here there is contract of indemnity between X and the company.

In a contract of indemnity, the promisee i.e., indemnity- holder acting within the scope of his authority is entitled to recover from the promisor i.e., indemnifier the following rights:

- (a) all damages which he may be compelled to pay in any suit
- (b) all costs which he may have been compelled to pay in bringing/ defending the suit and
- (c) all sums which he may have paid under the terms of any compromise of suit

It may be understood that the rights contemplated under section 125 are not exhaustive. The indemnity holder/ indemnified has other rights besides those mentioned above. If he has incurred a liability and that liability is absolute, he is entitled to call upon his indemnifier to save him from the liability and to pay it off.

### 1.47 Contract of Guarantee

A contract of guarantee is a contract to perform the promise made or discharge liability incurred by a third person in case of his default (Section 126).

There are three parties in a contract of guarantee. Surety- person who gives the guarantee, Principal debtor- person in respect of whose default the guarantee is given, Creditor- person to whom the guarantee is given.

Any guarantee given may be oral or written.

For *examples*, (1) where 'A' obtains housing loan from LIC Housing and if 'B' promises to pay LIC Housing in the event of 'A' failing to repay, it is a contract of guarantee.

(2) X and Y go into a car showroom where X says to the dealer to supply latest model of Zen to Y. In case of his failure to pay, he will be paying for it. This is a contract of guarantee because X promises to discharge the liability of Y in case of his defaults.

The principle of implied promise to indemnify surety (one who gives guarantee) is contained in Section 145 of the Act which provides that 'in every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety and the surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee but no sum which he has wrongfully paid.

The right of surety is not affected by the fact that the creditor has refused to sue the principal debtor or that he has not demanded the sum due from him.

What constitutes consideration in a case of guarantee is an important issue and is laid down in Section 127 of the Act. As per Section 127 of the Act "anything done or any promise made for the benefit of the principal debtor may be sufficient consideration to the surety for giving the guarantee.

For *example* 'A' had advanced money to 'B' on a bond hypothecating B's property stating that C is the surety for any balance that might remain due after realization of B's property. C was not a party to the bond. He, however, signed a separate surety bond two days subsequent to the advance of the money. It was held that the subsequent surety bond was void for want of consideration (*Nanak Ram vs. Mehnilal 1877, 1 Allahabad 487*).

### 1.48 Nature of Surety's Liability

As per Section 128 of the Act, the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. Thus it can be seen:

- (i) the liability of surety is the same as that of principal debtor
- (ii) where a debtor cannot be held liable on account of any defect in the document, the liability of the surety also ceases
- (iii) surety's liability continues even if the principal debtor has not been sued or is omitted

from being sued. This is for the reason that the liability of the surety is separate on the guarantee.

### 1.49 Continuing Guarantee

A guarantee which extends to a series of transactions is called a 'continuing guarantee' (Section 129). *Examples:* 1. Where 'A' promises 'B' to be responsible, so long 'B' employs only 'C' to collect his rentals from tenants for an amount of ₹ 5000/-, there is a continuing guarantee by A to B so long 'C' is employed as rent collector. In other words A stands a guarantor to 'B' for rent collected by 'C'.

In the continuing guarantee, the liability of surety continues till the performance or the discharge of all the transactions entered into or the guarantee is withdrawn.

There are two important aspects regarding the revocation of continuing guarantee are:

1. The first aspect is "the continuing guarantee may at any time be revoked by the surety as to future transactions by notice to creditors". However no revocation is possible where a continuing relationship is established. For *instance* where 'A' becomes surety of 'C' for B's conduct as manager in C's bank and 'B' is appointed on the faith of this guarantee, 'A' is precluded from annulling the guarantee so long as B acts as manager in C's bank.

2. The second aspect is upon the death of surety, the continuing guarantee is revoked for all future transactions in the absence of any contract to the contrary.

### 1.50 Discharge of a Surety

Sections 133 to 139 of the Act lay down the law as to when a surety would be discharged.

These are as follows:

- (i) where there is any variance in the terms of contract between the principal debtor and creditor without surety's consent it would discharge the surety in respect of all transactions taking place subsequent to such variance.

Where 'A' stands to 'C' as surety for 'B' for rent payable by 'B' to 'C' for 'C's house and if B & C agree on a higher rent without A's consent, 'A' would stand discharged for the entire rent amount accruing after the date of variance.

- (ii) the surety is discharged if the principal debtor is discharged
  - (a) by a contract or
  - (b) any act or
  - (c) any omission the result of which is the discharge of principal debtor

For *instance* where 'A' contracts with 'B' to build a house for him and if 'C' stands as surety for 'B', 'C' as surety will stand discharged if 'A' discharges 'B' of his obligation to build house. Yet another *example* could be where 'A' agrees to build a house for 'B' if 'B' supplies the necessary timber and if 'C' stands as surety for A's performance. If 'B' fails to supply the

timber, both 'A' and 'C' stand discharged.

There are certain exceptions to the above rule. These are given hereunder: -

- (a) A mere forbearance on the part of a creditor to sue the debtor or to enforce any other remedy would not discharge the surety in the absence of any specific provision.
- (b) Even where the claim is barred by limitation, surety is still responsible. In *Krishto Kishore vs. Radha Romun I.L.R. 12 Cal.330*, the plaintiff sued the principal debtor and the surety for arrears of rent. The plaintiff also made the legal representatives of the principal debtor a party after knowing about the death of the principal debtor to avoid the debt being barred by limitation. It was held that even if debt is barred by limitation on account of death of principal debtor, the surety is still liable. The same view was confirmed by Privy Council in *Mahant Singh vs U Ba Yi A.I.R 1939 P.C 110* where it was held that omission of the creditor to sue within the period of limitation does not discharge the surety.
- (iii) Where the principal debtor compounds [settles] with the creditor regarding the amount or promises not to sue, the surety will be discharged. But a contract for giving time to a debtor is entered into with a third party, the surety will not be discharged. Where there are co-sureties release of one co-surety would not automatically discharge the other co-sureties. Further in between other co-sureties, the released co-surety is not absolved of his liability vis a vis other co-sureties.
- (iv) the surety would be discharged if the creditor does anything or acts in a manner which
  - (a) is inconsistent with the rights of surety and
  - (b) impairs the eventual remedy of the surety.

For example, 'A' puts 'M' as the cashier under B and agrees to stand as surety provided 'B' checks the cash every month. 'M' embezzles cash. 'A' was not held to be responsible as B failed to verify the cash every month.

### 1.51 Rights of Surety against the Principal Debtor and Creditor

After the performing of the promise or discharging of the liability of the principal debtor, surety acquires various rights against the parties.

The rights of surety are contained in sections 140 and 141 of the Act. These are

#### (1) Against the principal debtor

- (a) **Right of subrogation:** where a guaranteed debt has become due or default of the principal debtor to perform a guaranteed duty has taken place, the surety upon payment or performance of all that he is liable for, is vested with all the rights which the creditor had against the principal debtor. The right of the surety is known as the right of subrogation namely the right to stand in the shoes of the creditor.
- (b) **Right to securities:** the surety is entitled to the benefit of all securities made available to

the creditor by the principal debtor whether the surety was aware of its existence or not.

- (c) **Right to recover the amount paid/ Right to indemnity** : the surety is entitled to recover from the principal debtor whatever sums he has rightfully paid. In this connection the following principles were laid down in *Reed vs. Norris*
- (i) the claim of the surety is restricted to that smaller amount which he may have paid under the principle of "accord and satisfaction". Surety is not entitled for higher amount than what he has paid.
  - (ii) surety can also claim indemnity for any special damages which he has suffered while discharging his duties
  - (iii) surety can claim even if he has paid a time barred debt as it is a rightful payment though there are contrary views on this issue.

In all the above instances surety can claim reimbursements only if actual payments have been made and not where he has merely executed promissory notes. [*Panth Narayana Murthy vs. Marimuthu (1902) 26 Mad. 322,328*]

Where surety becomes surety without the knowledge of principal debtor, he is entitled for all the rights against the principal debtor but not the right to claim an indemnity against the principal debtor.

**(2) Sureties right against the creditor:** Following are the rights of sureties against the creditor:

- (a) **Right of subrogation:** the surety gets the right of subrogation for all payments and performances he is liable. This right would accrue only when the surety has paid the amount of liability in full. For *example* where a creditor had the right to stop the goods or sellers lien, surety would enjoy the same right after he has paid the amount [*Imperial Bank vs. SL Kathereine Docks 1877 5 Ch.D*]
- (b) **Right to securities:** surety is entitled for all securities which the debtor has provided to creditor whether surety is aware of it or not. Where a creditor loses any of the security by default or negligence the liability of the surety abates proportionately. If a creditor does not hand over the securities to surety he can be compelled to do so. Classic *examples* of surety's right are: he is entitled for all mortgage rights which the secured creditor has. But the surety is not entitled for any security provided subsequent to the contract of guarantee
- (c) **Right to sue:** surety has a right to require the creditor to sue for and recover the guaranteed debt. This right of surety is known as right to file a '*Quia timet action*' against the debtor. There is of course an inherent risk of having to indemnify the creditor for delay and expense
- (d) **Right to dismiss:** surety has a right to call upon the creditor to dismiss the person from service if the person whose fidelity is guaranteed by surety is persistently dishonest
- (e) **Right to claim set-off:** surety has a right of set off against the principal debtor exactly as

a creditor would have.

- (f) **Right of option on the claim of the funds:** surety also can compel the creditor where he has claim on two funds, to resort to that fund first on which surety has no claim.
- (g) **Right to claim :** surety can claim that he is not liable on the guarantee to the creditor, if it can be proved that principal debtor was incapable of entering into a contract, say because he was a minor.

This is on the principle that the liability of the surety is co-extensive with that of the principal debtor.

**Guarantee when valid:** Following are the circumstances when a guarantee can be treated as invalid.

- (i) **Mis-representation:** when the guarantee has been obtained by means of mis-representation made directly by the creditor or made with his knowledge and the mis-representation relates to a material part of the transaction.
- (ii) **Silence as to material circumstances:** when the creditor has obtained any guarantee by means of keeping silence as to material circumstances.

The expression "keeping silence" implies intentional concealment of a material fact, as distinct from a mere non-disclosure thereof. There must exist some element of fraud. [*Balakrishna vs. Bank of Bengal (1891) 15 Bom. 585*]. Thus, A engages B as clerk to collect money for him and B fails to account for some of his receipts. Thereupon, A calls upon B to furnish security for his duly accounting the receipts. C gives the required guarantee. A does not tell C of the fact of a previous misappropriation by B and thereafter B again makes a default. The guarantee would be invalid.

- (iii) **Failure of joining of other person as co-surety:** when a contract of guarantee is entered into on the condition that the creditor shall not act upon it until another person has joined in it as co-surety and that other party fails to join as such.

## 1.52 Contribution as between Co-Sureties

As per section 146 of the Act "when two or more persons are co-sureties for the same debt, or duty, either jointly, or severally and whether under the same or different contracts and whether with or without the knowledge of each other, the co-sureties in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor".

A co- surety gets a right to recover from other sureties only when he has paid more than his share of debt to the creditor.

**Liability of two sureties is not affected by mutual arrangements :** As per section 132 of the Act “where two persons contract with a third person to undertake a certain liability and also contract with each other that one of them shall be liable only on the default of the other, third person not being a party to such contract, the liability of each of such two persons to the third person under the first contract is not affected by the existence of the second contract, although such third person may have been aware of its existence”.

The foregoing is the position of law applicable when the liability is undertaken jointly by two parties in respect of the same debt. But it is not so when it is in respect of different debts. For *example*, a party who accepts a Bill of Exchange for the accommodation of another would plead that he was the accommodating party. This is because the liability undertaken by the acceptor and drawer of the bill is in no sense a joint liability. Though they contract to pay the same sum of money, they contract severally in different ways and subject to different conditions. [*Pages vs. Bank of Bengal (1877) 3 Cal. 174*].

### **1.53 Distinction between a Contract of Indemnity and a Contract of Guarantee**

We have in previous para learnt in detail about the contract of indemnity and a contract of guarantee. Now let us analyse the differences between the two.

- (i) **Number of parties:** In a contract of indemnity there are only two parties namely the indemnifier [promisor] and the indemnified [promisee]. In a contract of guarantee there are three parties creditor, principal debtor and surety.
- (ii) **Extent of liability:** The liability of the indemnifier is primary and independent. The liability of the surety is secondary as the primary liability is that of the principal debtor.
- (iii) **Time of liability:** The liability of the indemnifier arises only on the happening of a contingency. In the case of guarantee, liability is already in existence but specifically crystallizes when principal debtor fails.
- (iv) **Time to Act:** The indemnifier need not necessarily act at the request of indemnified. In case of guarantee surety must act by extending guarantee at the request of debtor.
- (v) **Right to sue third party:** In case of contract of indemnity, indemnifier cannot sue a third party for loss in his own name as there is no privity of contract. Such a right would arise only if there is an assignment in his favour. On the other hand in the case of contract of guarantee surety can proceed against principal debtor in his own right because he gets all the right of a creditor after discharging the debts.

**Key Points**

- ◆ A contract of indemnity- A contract where one party promises to indemnify the other from loss caused to him by the conduct of the promisor or by the conduct of any other person.
- ◆ A contract of guarantee- A contract to perform the promise or discharge the liability of a third person in case of his default.
- ◆ Contract of guarantee must be supported by consideration. The consideration received by the principal debtor may be sufficient consideration to the surety for giving guarantee.
- ◆ The liability of surety is co-extensive with that of principle debtor. In certain cases surety will be liable though principal debtor is not liable- (i) principal debtor is incompetent to contract.(ii) principal debtor is adjudged insolvent.(iii) the debts becomes time-barred.
- ◆ Specific/ simple guarantee-Guarantee for single debt/particular transaction.
- ◆ Continuing guarantee-Guarantee that extends to a series of transactions.
- ◆ A contract of guarantee becomes invalid, when -(i) Obtained by misrepresentation (ii) Obtained by concealment of material facts (iii) Co-surety does not join (iv) When consideration fails.



## UNIT – 8 : BAILMENT AND PLEDGE

### Learning objectives

After studying this unit, you would be able to –

- ◆ Understand the general principles underlying contracts of bailment and pledge.
- ◆ Grasp the duties and rights of the parties to the contracts.

### 1.54 What is bailment?

Bailment etymologically means 'handing over' or 'change of possession'. As per Section 148 of the Act, bailment is an act whereby goods are delivered by one person to another for some purpose, on a contract, that the goods shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person who delivers the goods is the bailor and the person to whom the goods are delivered is the bailee.

For *example* where 'X' delivers his car for repair to 'Y', 'X' is the bailor and 'Y' is the bailee.

The essential characteristics of bailment are-

- (a) Bailment is based upon a contract. Sometimes it could be implied by law as it happens in the case of finder of lost goods.
- (b) Bailment is only for moveable goods and never for immovable goods or money.
- (c) In bailment possession of goods changes. Change of possession can happen by physical delivery or by any action which has the effect of placing the goods in the possession of bailee.
- (d) In bailment bailor continues to be the owner of goods as there is no change of ownership.
- (e) Bailee is obliged to return the goods physically to the bailor. The bailee cannot deliver some other goods, even not those of higher value.

**General issues:** In bailment both custody and possession must change but not the ownership. But where a person is in custody without possession he does not become a bailee. For *example* servants of a master who are in custody of goods of the master do not become bailees.

Possession and custody do not however mean physical delivery of goods. Constructive delivery could also create a bailor and bailee relationship. This arises in situations where the bailee is already in possession of goods but agrees to be a bailee through a contract.

Deposit of money in a bank is not bailment since the money returned by the bank would not be identical currency notes.

Similarly depositing ornaments in a bank locker is not bailment, because ornaments are kept in a locker whose key are still with the owner and not with the bank. The ornaments are in

possession of the owner though kept in a locker at the bank.

**Different forms of Bailment:** Following are the popular forms of bailment

- (1) Delivery of goods by one person to another to be held for the bailor's use.
- (2) Goods given to a friend for his own use without any charge
- (3) Hiring of goods.
- (4) Delivering goods to a creditor to serve as security for a loan.
- (5) Delivering goods for repair with or without remuneration.
- (6) Delivering goods for carriage.

### 1.55 Bailor's Duties and Rights

**Duties of Bailor:** The duties of bailor are spelt out in a number of Sections. These are enumerated hereunder:

- (i) the bailor must disclose all defects/faults in the goods bailed. If the bailor does not disclose, he would be responsible for any loss or damage suffered by the bailee while keeping the goods in his custody. The bailor is particularly responsible for defects in goods hired to bailee whether bailor was aware of such defects or not.
- (ii) where the bailment is gratuitous, the bailor must reimburse the bailee for any expenditure incurred in keeping the goods.
- (iii) the bailor should reimburse any expense which the bailee may incur by way of loss in the process of returning the goods or complying with other directions for returning the goods.
- (iv) the bailor must compensate the bailee for the loss or damage suffered by the bailee that is in excess of the benefit received, where he had lent the goods gratuitously and decides to terminate the bailment before the expiry of the period of bailment.
- (v) the bailor is bound to accept the goods after the purpose is accomplished. If bailor fails, he is responsible for any loss or damage to the goods and has to reimburse for expenses incurred by the bailee for keeping the goods safely.

**Rights of Bailor:** The following are the rights of bailor:

- (1) Bailor has a right to enforce the duties of the bailee such as -
  - (a) right to claim damages for loss caused to the goods by the negligence of bailee;
  - (b) right to claim compensation for loss caused by an unauthorized use of the goods bailed;
  - (c) right to claim damages arising out of mixing the goods of the bailor with his own goods.
- (2) Bailor has a right to terminate the contract if the bailee does anything which is inconsistent with the conditions of bailment. For *example* 'A' lets on hire his horse to 'B'

for his own riding but 'B' uses the horse for driving his carriage. 'A' has a right to terminate the contract of bailment.

- (3) Bailor in the case of gratuitous bailment has a right to demand the goods back even before the expiry of the period of bailment. If in the process, loss is caused to the bailee, bailor is bound to compensate.
- (4) Bailor has a right to claim the increase or profit from the goods bailed which may have occurred from the goods value. For *example* where 'A' bails his cow to 'B' and if the cow gives birth to a calf, 'B' is bound to return the cow and the calf to 'A'.

### 1.56 Care to be taken by Bailee

The bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence with regard to quantity, bulk and value would take.

In such a case he will not be responsible, in the absence of special contract, for any special loss or destruction or deterioration of the goods bailed, since he has taken as much care as a man of ordinary prudence.

For *example* if X bails his ornaments to 'Y' and 'Y' keeps these ornaments in his own locker at his house along with his own ornaments and if all the ornaments are lost/stolen in a riot 'Y' will not be responsible for the loss to 'X'. If on the other hand 'X' specifically instructs 'Y' to keep them in a bank, but 'Y' keeps them at his residence, then 'Y' would be responsible for the loss [caused on account of riot].

**Bailee has right to terminate:** The bailee has the right to terminate a contract of bailment if the bailor does any thing inconsistent with bailment conditions.

### 1.57 Duties and Rights of a Bailee.

In addition to the two important duties of having to take care of the goods bailed and being responsible for loss/injury/damage to goods, bailee has other following duties under the Act.

- (i) Bailee has no right to make unauthorized use of goods bailed
- (ii) Bailee has no right to mix the goods bailed with his own goods without the consent of the bailor.
- (iii) Bailee has to return the goods on expiration of period of bailment
- (iv) Bailee has a duty to return any extra profit accruing from goods bailed. Where A bails his cow to 'B' and if the cow gives birth to a calf, 'B' must return both the cow and the calf to 'A'
- (v) Bailee has duty not to do anything inconsistent with the condition of bailment.

**Rights of bailee:** The bailee has the following rights [These rights are also the duties of the bailor]-

- (i) to claim compensation for any loss arising from non-disclosure of known defects in the

goods

- (ii) to claim indemnification for any loss or damage as a result of defective title.
- (iii) to deliver back the goods to joint bailors according to the agreement or directions
- (iv) to deliver the goods back to the bailor whether or not the bailor has the right to the -- goods
- (v) to exercise his 'right of lien'. This right of lien is a right to retain the goods and is exercisable where charges due in respect of goods retained have not been paid. The right of lien is a particular lien for the reason that the bailee can retain only these goods for which the bailee has to receive his fees/remuneration.
- (vi) to take action against third parties if that party wrongfully denies the bailee of his right to use the goods

#### **Suit by bailor & bailee against wrong doers**

Both bailor and bailee have right to sue a third party who has deprived the bailee to the use or possession of goods bailed. Any relief obtained against such deprivation or injury can be shared between the bailor and bailee according to their respective interest.

### **1.58 Rights and Duties of Finder of Goods**

We have already seen in an earlier study unit, that the duties of 'finder of lost goods' are that of the bailee. Such a 'finder of lost goods' is as good as a bailee and he enjoys all the rights and carries all the responsibilities of a bailee.

Apart from the above, the 'finder of lost goods' can ask for reimbursement for expenditure incurred for preserving the goods but also for searching the true owner. If the real owner refuses to pay compensation, the 'finder' cannot sue but retain the goods so found.

Further where the real owner has announced any reward, the finder is entitled to receive the reward. The right to collect the reward is a primary and a superior right even more than the right to seek reimbursement of expenditure.

Lastly the finder though has no right to sell the goods found in the normal course, he may sell the goods if the real owner cannot be found with reasonable efforts or if the owner refuses to pay the lawful charges subject to the following conditions:

- a) when the article is in danger of perishing and losing the greater part of the value or
- b) when the lawful charges of the finder amounts to two-third or more of the value of the article found.

### **1.59 General Lien and Particular Lien**

A general lien is the right to retain the property of another for a general balance of account. In contract the particular lien is the right to retain the particular goods bailed for non-payment of

charges/remuneration.

Bankers, factors, wharfingers, policy brokers and attorneys of law have a general lien in respect of goods which come into their possession during the course of their profession.

For *instance* a banker enjoys the right of a general lien on cash, cheques, bills of exchange and securities deposited with him for any amounts due to him. For *instance* 'A' borrows ₹ 500/- from the bank without security and subsequently again borrows another ₹ 1000/- but with security of say certain jewellery. In this illustration, even where 'A' has returned ₹ 1000/- being the second loan, the banker can retain the jewellery given as security to the second loan towards the first loan which is yet to be repaid.

Under the right of general lien the goods cannot be sold but can only be retained for dues. The right of lien can be waived through a contract.

Interestingly, Chartered Accountants have a general lien against the books of their clients which come into their possession against professional fees not paid to them by those clients.

**Particular lien:** In accordance with the purpose of bailment if the bailee by his skill or labour improves the goods bailed, he is entitled for remuneration for such services. Towards such remuneration, the bailee can retain the goods bailed if the bailor refuses to pay the remuneration. Such a right to retain the goods bailed is the right of particular lien. He however does not have the right to sue.

Where the bailee delivers the goods without receiving his remuneration, he has a right to sue the bailor. In such a case the particular lien may be waived. The particular lien is also lost if the bailee does not complete the work within the time agreed.

**Difference between general lien and particular lien:** The difference between the two can be summarised as follows:

General lien	Particular lien
It is a right to detain/retain any goods of the bailor for general balance of account outstanding	It is a right exercisable only on such goods in respect of which charges are due.
A general lien is not automatic but is recognized through an agreement. It is exercised by the bailee only by name	It is automatic
It can be exercised against goods even without involvement of labour or skill.	It comes into play only when some labour or skill is involved
Bankers, factors, wharfingers, policy brokers etc. are entitled to general lien	Bailee, finder of goods, pledgee, unpaid seller, agent, partner etc are entitled to particular lien

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**Key Points**

- ◆ Bailment-Delivery of goods by one person to another for some purpose upon a contract that they shall be returned after the purpose is over or disposed off according to the directions of the person delivering them.
- ◆ Bailor- Person who delivers goods for bailment.
- ◆ Bailee- Person to whom goods are delivered under the contract of bailment.
- ◆ Depositing currency notes in a bank- It is not a bailment as currency notes or moneys are not goods as per the definition of goods given under the Sale of Goods Act,1930 and also no same notes is returned to the depositor by the bank.
- ◆ Keeping of ornaments/valuables in a bank locker- It's not a bailment as there is no transfer of possession of ornaments or valuables.
- ◆ Gratuitous bailment- No consideration passes between the bailor and the bailee and the bailor is not responsible for the damages in respect of the faults which were not known to him.

**1.60 Pledge**

Pledge is a variety or specie of bailment. It is bailment of goods as security for payment of debt or performance of a promise. The person who pledges[or bails] is known as pledgor or also as pawnor, the bailee is known as pledgee or also as pawnee. In pledge, there is no change in ownership of the property. Under exceptional circumstances, the pledgee has a right to sell the property pledged. Section 172 to 182 of the Indian Contract Act,1872 deal specifically with the bailment of pledge.

For *example*: A lends a money to B in lieu of a jewellery deposited by B as security to A. This bailment of jewellery is a pledge as security for lending the money. B is a pawnor and the A is a pawnee.

Let us now examine the essentials of pledge and rights of pawnee and pawnor.

Essentials of contract of pledge:

There must be bailment for security for payment of debt/ performance of a promise.

Goods must be the subject matter of the contract of pledge.

The goods pledged must be in existence.

There must be a delivery of goods from pawnor to pawnee

**Pawnee's rights**

**(a) Right of retainer:** Pawnee has right to retain the goods pledged not only for payment of debt or performance of a promise but also for recovery of debts and all expenses incurred for

preservation of goods pledged. Where 'M' pledges stock of goods for certain loan from a bank, the bank has a right to retain the stock not only for adjustment of the loan but also for payment of interest.

**(b) Right to retention to subsequent debts:** Pawnee has a right to retain the goods pledged towards subsequent advances as well, however subject to such right being specifically contemplated in the contract.

**(c) Right to seek reimbursement of extraordinary expenses:** Pawnee has a right to seek reimbursement of extraordinary expenses incurred. However his right to retain the goods shall not extend to such extraordinary expenses but is restricted to ordinary expenses.

**(d) Right to sue:** In the event of pawnor failing to redeem the debt or perform the promise, the pawnee has a right to sue the goods which he has retained. He can in the alternative, under certain circumstances, sell the goods after giving a reasonable notice, to the pledgor. The two rights namely the right to sue and the right to sell are alternative rights and not cumulative rights.

#### **Rights of a pawnor**

**(a) Right to redeem:** Pawnor has a basic right to redeem the goods pledged by performing his promise.

**(b) Right to sue:** Pawnor has a right to sue, but within a period of 3 years in view of provision of Limitation Act only in the event of pawnee refusing to return the goods even after payment of debt etc.

**(c) Right to take care of the goods:** Pawnor has a right to demand a pawnee to take all reasonable care and preservation of the goods pledged.

**(d) Right to receive increase or profit from the goods:** Pawnor is entitled to receive the increase or profit from the goods if there is any increase/profit relating to it during the pledged period

### **1.61 Pledge by Mercantile Agents**

Though generally only a owner of goods can pledge, the Act recognizes the right of certain mercantile agents to pledge provided it is done with the consent of the owner of the goods. Such a pledge done in the ordinary course of business is valid. Pledge in this case can be effected through pledge of documents like a bill of lading or a railway receipt etc.

### **1.62 Distinction between Bailment and Pledge**

There are three distinctions between bailment and pledge. These are

**(a) As to purpose:** Pledge is a variety of bailment. Under pledge goods are bailed as a security for a loan or a performance of a promise. In regular bailment the goods are bailed for other purpose than the two referred above. The bailee takes them for repairs, safe custody etc.

(b) **As to right of sale:** The pledgee enjoys the right to sell only on default by the pledgor to repay the debt or perform his promise, that too only after giving due notice. In bailment the bailee, generally, cannot sell the goods. He can either retain or sue for non-payment of dues.

(c) **As to right of using goods:** Pledgee has a right to use goods. A bailee can, if the terms so provide, use the goods.

(d) **Consideration:** In pledge there is always a consideration whereas in a bailment there may or may not be consideration.

(e) **Discharge of contract:** Pledge is discharged on the payment of debt or performance of promise whereas bailment is discharged as the purpose is accomplished or after specified time.

#### Key Points

- ◆ Pledge- Bailment of goods as security for payment of a debt/performance of a promise.
- ◆ Pawnor- Person who pledges goods as security.
- ◆ Pawnee- Person who receives the goods as security.
- ◆ Rights of Pawnor - To get back the goods, redeem the goods, take care and preserve the goods, receive increase or profits from the goods.
- ◆ Rights of Pawnee- To retain goods, to receive extra-ordinary expenses, to sue, to sell goods.
- ◆ Some non-owners may also create a valid pledge of goods, such as- Mercantile agents, co-owner, by person having a limited interest, by person having a possession of goods under voidable contract.
- ◆ Basic distinction between bailment and pledge- All the pledges are bailments but all the bailments are not a pledges.



## UNIT – 9 : AGENCY

### Learning objectives

After studying this unit, you would be able to –

- ◆ Understand the relationship between agent and principal and the intention behind adoption of such course of agency.
- ◆ Note that consideration is not at all necessary for validity of agency contracts.
- ◆ Learn various modes of creation, especially agency by ratification.
- ◆ Understand rights and obligations of an agent as well as the circumstances when the agent is personally liable for the acts done by him on behalf of the principal and the legal position of the agent, the principal and the third parties involved.
- ◆ Be familiar with the terms 'sub-agent' and 'substituted agent' and to distinguish between the two.

In the modern world conduct of business is not possible without the help of agents. Therefore it is necessary to know the law relating to agency. The law of agency is contained in sections 182 to 238 of the Indian Contract Act, 1872.

### 1.63 What is Agency?

The Indian Contract Act, 1872 does not define the word 'Agency'. However the word 'Agent' is defined as "a person employed to do any act for another or to represent another in dealings with third persons". The third person for whom the act is done or is so represented is called "Principal". (Section 182)

Thus 'Agency' is a comprehensive word used to describe the relationship between one person and another, where the first mentioned person brings the second mentioned person into legal relation with others.

The Rule of Agency is based on the maxim "Qui facit per alium, facit per se:" i.e., he who acts through an agent is himself acting

**Salient features of agency:** Following are the four salient features of agency

- (i) **Basis:** The basic essence of 'agency' is that the principal is bound by the acts of the agent and is answerable to third parties.
- (ii) **Consideration not necessary:** Unlike other regular contracts, a contract of agency does not need consideration. In other words, the relationship between the 'principal' and 'agent' need not be supported by consideration.
- (iii) **Capacity to employ an agent:** A person who is competent to contract alone can employ

an agent. In other words, a person in order to act as principal must be a major and of sound mind.

- (iv) **Capacity to be an agent:** A person in order to be an agent must have authority to contract. So, minor has no capacity to contract but may have authority to act as agent. An agent brings about a contractual relationship between the principal and third persons and therefore his contractual capacity is immaterial.

### 1.64 Modes of Creation of Agency

There are five general methods of creating agency. These are (i) agency by actual authority (ii) agency by ratification (iii) agency of ostensible authority (iv) agency by necessity and (v) agency by actual authority and apparent authority.

Let us briefly discuss these five modes of creation of agency.

**(a) Agency by actual authority:** A contract of agency can be express or implied. Whether it is express or implied, it can be by words spoken or written. While the express contract is often expressed in clear terms, implied contracts are created by circumstances.

For *example*, 'A' owns a shop and 'B' manages that shop. Though 'A' being the owner orders purchases for that shop and pays through his bank account, 'B' by virtue of his position can also purchase as an agent, express or implied.

**(b) Agency by ratification:** Agency is also created by subsequent ratification or approach. The subsequent ratification becomes necessary because the agent acts without the knowledge or the approval of the principal. Following are the rules of ratification.

- (i) Ratification can be made only by a person who was in existence at the time of act.
- (ii) Ratification must be by a person for whom the act was done, professing him to be a principal. This implies competency on the part of the person ratifying the act.
- (iii) Ratification would date back to the date of the act, and validate it
- (iv) Ratification may either be express or even implied by the conduct of the person on whose behalf the act was done.
- (v) Ratification must be of the whole act and not just for a part of the act.
- (vi) Ratification [by the purported principal] of the acts of an agent can not be such as to create any liability to third parties or cause any injury or damage to third parties
- (vii) Ratification cannot be done if the person ratifying is in knowledge of facts which are materially defective.
- (viii) Illegal acts cannot be ratified.

- (ix) Acts which are void ab initio cannot be ratified
- (x) Ratification would be restricted to certain limitations to which original acts are limited and ratification can be to that portion of exceeded authority by the agent.

(c) **Agency by ostensible authority:** Where the authority of the principal is inferred by the conduct of the principal, there the agency through ostensible authority is born. Here the agent's authority is ostensible and the principal is bound by the act of the agent. Ostensible authority happens on account of estoppel and holding out. Let us analyse these two types with *examples*-

(i) *Agency by estoppels:* If a person permits or represents another to act on his behalf, so that a reasonable person would infer that the relationship of principal and agent had been created then he will be stopped from denying his agent's authority and getting himself relieved from his obligations to a third party by proving that no such relationship infact existed.

For *instance* where 'A' informs 'B' in the presence and within hearing of 'P' that 'P' is his agent. Later 'B' enters into contract with 'P' thinking that 'P' is the agent of 'A'. In a situation like this neither 'P' nor 'A' can refuse the obligations under the contract. 'P' had become the agent of 'A' by estoppel. 'P' will be treated as agent of 'A' even if he was not an agent at all.

Where a master permits his servant to pledge his credit, there is an agency on account of estoppel. Even if the servant had on occasion pledged without the authority of master, the master is still bound because of estoppel. Similarly where a married woman co-habits with her husband, there is a presumption that she has the authority to pledge his credit for necessities.

A principal cannot privately revoke or restrict the authority of his agent, which he has allowed in public.

(ii) *Agency by Holding out:* Under the principle of holding out, any one who holds himself out as an agent of another, then a relationship of agent and principal gets in place. The process of holding out happens through willful conduct done to create a deliberate impression. In such a case person concerned is estopped from denying that he is the agent of a principal. The doctrine of holding out is also applicable in case of partnerships. The law of partnership also adopts the principle of agency to a large extent. However under "holding out" principle following conditions are required to be present:

- (a) statement or conduct of misrepresentation
- (b) a genuine not necessarily a fraudulent misrepresentation and
- (c) the third person should prove that he entered into the transaction believing the statement so made.

(d) **Agency by necessity:** Sometimes circumstances would compel and a relation of agency would fall in place. This is often out of necessity. For *example* a captain of a ship can borrow money at other ports where there are no agent to act on behalf of the owner, to carry out repairs. The captain becomes an agent by necessity. To constitute an agency by necessity following conditions must be fulfilled.

- (i) agent should be in a position of not being able to communicate in time with the principal
- (ii) there must have been an actual and definite commercial necessity
- (iii) the agent must have acted bonafide and for the benefit of principal
- (iv) the agent must have adopted most reasonable and practicable course of action.

(e) **Actual authority and apparent authority:** Actual authority to act as agent stems from a consent. The consent to act may be oral or in writing. Some time the authority can also be 'implied authority'. The implied authority is incidental or usual or customary. It would depend on the circumstance of the case.

The authority of the agent is 'apparent' where the principal represents or is regarded by law as having represented that another has, authority. Under the doctrine of 'apparent authority', the 'principal' is bound to third parties by the acts of that person though he had not given such authority or had limited the authority by instructions not made known to third party. The notion of apparent authority is essentially confined to relationship between the principal and third party.

### 1.65 Extent of Agent's Authority

The agent's authority is governed by two principles namely (a) in normal circumstances and (b) in emergency.

Let us examine these two situations -

(i) **Agent's authority in normal circumstances:** An agent has the power and authority to do all acts lawful and necessary in the normal circumstances in discharge of his functions. For *instance*, where 'A' who lives in Andamans employs 'B' as his agent to collect his debts in Kanyakumari, 'B' has all the authority including the authority to pursue legal proceedings. Similarly 'B' can also give valid discharge. Again for *example*, where 'A' executes a power of attorney in favour of 'B' in running a silk factory, but the power of attorney did not authorize 'B' to borrow and if 'B' borrowed, it was stated to be an act in excess of his authority [*Ferguson vs. Uma Chand Bold* (1905) 33 Cal. 343]

(ii) **Agent's authority in emergency:** An agent has the authority in an emergency to do all such acts as a man of ordinary prudence would, for protecting his principal from losses under similar circumstances.

A typical case is where the 'agent' who handles perishable goods like 'mangoes' can decide the time, date and place of sale, not necessarily as per instructions of the principal but with the intention of protecting the principal from losses. Here the agent acts in an emergency and acts as a man of ordinary prudence.

**Notice to an agent:** Any notice given to an agent or information obtained by him will be deemed to be given to the principal. Thus where the agent of an insurance company negotiates with a customer who had lost an eye in an accident, the insurance company is deemed to have knowledge of the fact.

### 1.66 Duties and Obligations of an Agent

Following are the duties of an agent:

- (i) *Duty in conducting principal's business:* The agent should conduct the business of the principal as per directions of the principal or in the absence of any directions as per the custom prevalent in the business
- (ii) The agent is liable to the principal for any loss if he deviates from the above duty/obligation where he did not act according to instruction of the principal. It was held by the Supreme Court in a case that the agent had to compensate the principal where the agent did not act according to the instructions of the principal. In the given case the agent was under instruction to insure the goods of the principal but he did not. There was an explosion in the Bombay dock and as a result all the goods of the principal, along with others, was destroyed. The Government passed an ordinance that where ever there was a fire insurance policy, full amount would be paid to the owners and where there was no insurance cover, half the amount would repaid. The principal was paid half the losses and he sued the agent for the balance loss and the agent was ordered by court to pay the balance amount to compensate him for loss.
- (iii) *Requirements as to skill and diligence:* Agent must act always as a person with diligence and skill normally exercised in the trade. He would otherwise be responsible to compensate the principal for any loss suffered by the principal for want of his skill.

Where 'A' acts as an agent for 'B' and sells rice to 'C' in the usual course of business without verifying about C's solvency and if 'C' goes insolvent, then 'A' is responsible for losses arising to 'B'.

- (iv) *Agents duty to account:* The agent has to maintain and render proper accounts to principal whenever demanded. He is bound to pay the principal all sums received. He is bound to maintain accounts even if the contract is illegal or void.
- (v) *Duty to communicate:* The agent must in order to obtain instruction, communicate and contact the principal as a man of ordinary diligence.

### 1.67 Rights of An Agent

Following are the rights of an agent

(i) **Right of lien on principal's property:** An agent is entitled to retain the goods, properties and books for any remuneration, commission etc due to him. The possession of such property should be however lawful.

(ii) **Right of indemnification for lawful acts:** The principal is bound to indemnify the agent against all consequences of lawful acts done in exercise of his authority. For *example* 'A' of Delhi appoints 'B' of Mumbai as agent to sell his merchandise. As a result 'B' contracts to deliver the merchandise to various parties. But 'A' fails to send the merchandise to 'B' and 'B' faces litigations for non-performance. Here 'A' is bound to protect 'B' against the litigations and all costs, expenses arising out of that.

(iii) **Right of indemnification against acts done in good faith:** Where the agent acts in good faith on the instruction of principal, agent is entitled for indemnification of any loss or damage from the principal. Where 'P' appoints 'A' as his agent and directs him to sell certain goods which in fact turned out to be not those belonging to 'P' and if third parties sue 'A' for this act, 'A' is entitled for reimbursement and indemnification for such act done in good faith.

However the agent cannot claim any reimbursement or indemnification for any loss etc arising out of acts done by him in violation of any penal laws of the country.

(iv) **Right of retention:** The agent can retain, out of the sums received from the principal, such amounts towards reimbursement of expenditure, remuneration and advances paid by him on account towards the business and render accounts only for the balance.

(v) **Right of remuneration:** The agent in the normal course is entitled for remuneration as per the contract. In the absence of any agreed amount of remuneration, he is entitled for usual remuneration which is customary in the business. However he is not entitled for any remuneration for acts done through misconduct/negligence.

### 1.68 Personal Liability of the Agent

We have already seen that basic principle of agency is that agent acts on behalf his principal and therefore cannot personally enforce the contract. Similarly he is also not personally bound for any act.

However under certain circumstances like, where the agent exceeds his authority, or has no authority or the principal does not ratify the act of the agent, the agent is personally liable. This is known as doctrine of implied warranty of authority. The rules with regard to personal liability of an agent are set out hereunder.

- (i) where the contract expressly provides for personal liability of the agent
- (ii) where the agent signs the negotiable instrument without indicating that he is signing it for the principal
- (iii) where the agent works for a foreign principal
- (iv) where the agent acts for a principal who cannot be sued viz Ambassador of a country etc.
- (v) where a Govt. servant enters into a contract on behalf of Union of India in disregard of Article 299(1)
- (vi) where according to usage in trade in certain kinds of business agents are personally liable.
- (vii) where the agency is coupled with interest. An agency will be treated as such where the agent himself has interest in the subject matter. The 'interest' of the agent to come under this category should not be an ordinary 'interest' like towards remuneration etc., but should be a special interest.

### 1.69 Undisclosed Principal

An 'undisclosed principal' comes into play where an agent having the authority to contract, does not disclose the fact, concealing not only the name of the principal but also the fact that there is a principal; here the agent gives an impression that he acts on his own.

In 'undisclosed principal', the mutual rights, of principal, agent and third party are as follows:

- (a) the liability of the agent is his own since he has not disclosed that there is a principal
- (b) where the third party comes to know about the existence of the principal he can sue the agent or the principal.
- (c) the third party's interest would stand protected evenly, and would not suffer even if the principal surfaces and intervenes at a later date.
- (d) third party has a right to refuse, if the principal discloses himself, on the ground that had he known about the principal he would not have entered into the contract.

### 1.70 Principal's Liability for Agent's Act to Third Parties

The liability of the principal to third parties would fall under following categories -

- (a) **When agent acts within the scope of his authority:** The principal is liable for the acts of the agent done within the scope of his actual or apparent authority. Where there are specific restrictions on the authority of the agent, then the principal is not bound by it.

(b) **Principal is bound by notice given to agent:** The principal is bound by the notice given to the agent. Knowledge of the agent is knowledge of the principal. Knowledge of a bank manager is knowledge of the bank. Therefore the principal is bound except where the agent does acts that are fraudulent.

(c) **Liability by estoppels:** Where the agency is by the doctrine of estoppel, the principal is bound by the same doctrine.

(d) **Liability for misrepresentation:** The principal is liable for any fraud or misrepresentation done by the agent within his authority regardless of the fact that the act has resulted in benefit to the agent or the principal.

*No liability where agent exceeds the authority*

The principal is not liable for acts of agent done in excess of authority. Some times the acts can be separated as 'within the authority' and 'beyond the authority'. Principal is bound for those acts which are within the authority. But where acts are not separable, the principal may repudiate the entire transactions.

(e) **Unnamed principal:** Where the existence of the principal is known but his name is not known, the principal is liable for the acts of the agent. Third parties can sue the principal for the acts of the agent, unless agent refuses to disclose the identity of the principal.

### 1.71 Termination of Agent's Authority.

The termination of the agency arises and is based on the doctrine of revocation.

In terms of Section 201 of the Act, following are the circumstances when the authority conferred on the agent gets terminated:

- (a) Revocation of authority by the principal
- (b) Renunciation of agency by the agent
- (c) Completion of business of agency
- (d) Death or insanity of principal or agent and
- (e) Insolvency of the principal

The rights of the principal to revoke the authority of the agent and the right of the agent to renounce are each exercised at their will and pleasure.

Following are the general principles in this regard:

- (a) Even where the agent gets interested in the subject matter, that would not be a ground for the principal to terminate the agency. The agency becomes an agency coupled with interest.



- (b) The principal cannot revoke the authority after the authority has been exercised.
- (c) The agent's authority cannot be revoked if the agent has partially exercised the authority.
- (d) Where there is an implied or express contract, agency may continue for a period of time. The agency can not be terminated without compensation.
- (e) Reasonable notice must be given for termination, otherwise the agent is entitled for compensation.
- (f) Revocation and Renunciation must be express or implied.

### 1.72 Irrevocable Agency

Where the agency cannot be terminated, it is called irrevocable agency.

- (a) *Where agency is coupled with interest* then it is a case where the agent has interest in the subject matter of agency. In this case, agency cannot be terminated except where there is an express provision, to cause prejudice to the interest of the agent. For the agency coupled with interest does not come to an end on the death, insanity, or the insolvency of the principal.
- (b) *Where the agent has incurred personal liability*, principal cannot revoke the agency leaving the agent to face the liability. For *instance* where 'A' appoints 'B' as his agent and 'B' purchases as per orders of 'A' some rice in his personal name, A cannot revoke the authority
- (c) Where the *agent has partly exercised the authority*, the authority cannot be revoked, where 'A' appoints 'B' as his agent to procure 10 bags of rice and 'B' procures in the name of 'A' then 'A' cannot revoke his authority.

### 1.73 Sub- Agent

Sub agency refers to case where an agent appoints another agent. The appointment of sub agent is not lawful, because the agent is a delegatee and a delegatee cannot further delegate. This is based on the Latin principle "*delegatus non potest delegare*".

The appointment of a sub agent would be valid if the terms of appointment originally contemplated it. Sometimes customs of the trade may provide for appointment of sub agents. In both these cases the sub agent would be treated as the agent of the principal.

Position of sub agent vis a vis third parties where the sub agent is properly appointed

- (a) **Where the sub-agent is properly appointed:** Where a sub agent is properly appointed, the principal is bound by his acts and is therefore responsible to third parties as if he were an agent originally appointed by the principal.

(b) **In the case of appointment without authority:** In case where the appointment of sub agent takes place without authority, the principal is not bound by the acts of sub agent and sub agent is not bound to the principal. It is the agent who is the principal of sub agent. Where the sub-agent purportedly acts in the name of first principal, that first principal may ratify the act of sub agent. However if the sub agent acts in his own name or in the name of the agent who has without authority delegated to the sub agent the business which is in fact of the principal, the principal cannot ratify such acts of sub agent.

### 1.74 Substituted Agent

Substituted agents are not sub agents. They are agents of the principal. Where the principal appoints an agent and if that agent identifies another person to carry out the acts ordered by principal, then the second person is not to be treated as a sub agent but only as an agent of the original principal.

For *example*, 'A' directs 'B' his solicitor to sell his property by auction and 'B' appoints 'C' an auctioneer. In this regard, 'C' is an agent of 'A' and not a sub agent.

While selecting a "substituted agent" the agent is bound to exercise same amount of diligence as a man of ordinary prudence and if he does so he will not be responsible for acts or negligence of the substituted agent.

For *example* 'X' consigns goods to 'Y' a merchant for sale. 'Y' in due course employs an auctioneer in goods to sell goods of 'X' and also allows him to receive the proceeds of sale. The auctioneer becomes insolvent afterwards without handing over the proceeds. Here 'Y' will not be responsible to 'X' as he has discharged his duties as a man of ordinary prudence and diligence.

#### Key Points

- ◆ Agency- Relation between an agent and his principal created by an express/ implied agreement authorising an agent by his principal to create contractual relations with third parties. Person so appointed to represent the principal is called as agent whereas a person who appoints an agent to represent him as per his directions and authority is called as principal.
- ◆ Any person (competent/incompetent to contract) can be appointed as agent whereas principal needs to be competent to contract.
- ◆ Mode of creation- Agency can be either expressed or implied. It also arises by subsequent ratification or acceptance of the agent acts by the third person without the authority of the principal. Where a principal by his conduct or act causes a third person to believe that a certain person is his authorized agent, the agency is created by estoppel. The agency which is the result of principal's conduct as to the agent, there agency is said to be created by holding out. Agency by necessity comes into existence when certain circumstances compel a person to act as an agent for another without his express authority. It also arise by operation of law.

- ◆ Undisclosed principal- Where agent not discloses the existence of his principal and the fact of his being agent of the principal, there the principal of such agent is known as undisclosed principal. Where agent discloses his representation to the principal but not discloses the principal's name, there the principal is known as unnamed principal.
- ◆ Sub-agent-person appointed by the original agent in the business of agency under his direction and control and being responsible to the principal for acts of a sub-agent.
- ◆ Substituted agent/Co-agent –person is named by the agent expressly or impliedly to act for the principal in the business of agency.
- ◆ Irrevocable agency- agency which cannot be terminated by the principal.